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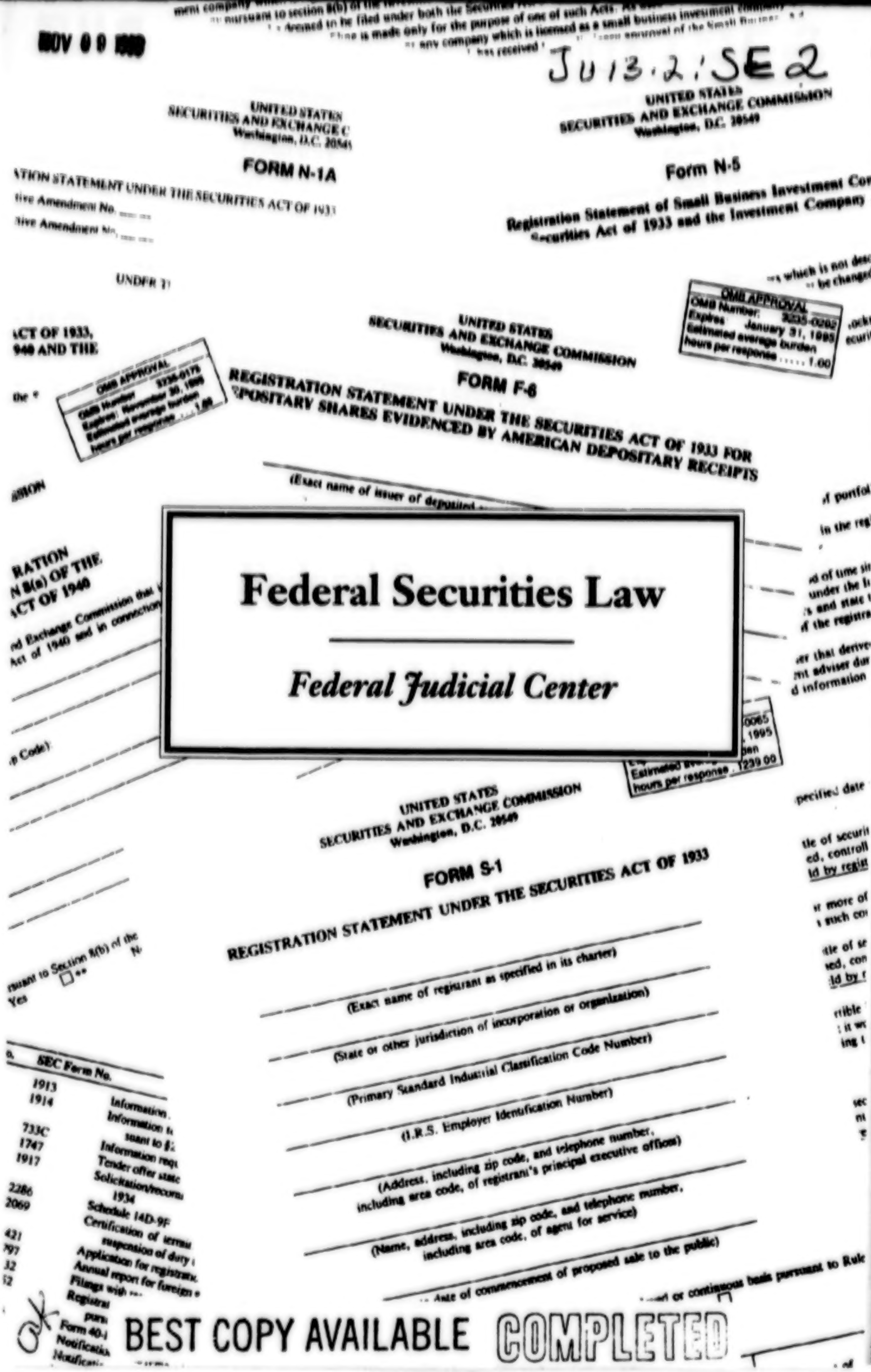

Federal Securities Law

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Federal Securities Law

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Federal Judicial Center
1993

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√

Introduction

This monograph provides an introduction to the intricacies of federal securities law. Litigation involving the federal securities laws can be extremely complex and esoteric. Because the vast majority of securities litigation involves either antifraud or registration and disclosure requirements, this monograph focuses primarily on those issues. Securities laws also govern the operation of the securities markets and securities professionals, through an elaborate scheme of self-regulation, as well as the regulation of investment companies and investment advisers. An overview cannot possibly address every issue. This monograph is written for federal judges and thus focuses on the issues that are most likely to arise in litigation: basic registration, disclosure, and antifraud provisions. Appendix A contains a list of selected references for further reading.

Codification of the securities laws is extremely confusing. There are seven federal securities statutes. The acts referred to most frequently in this primer are the Securities Act of 1933 and the Securities Exchange Act of 1934. As is the case with all of the federal securities laws, the section numbers of the acts do not coincide with the U.S. Code cites. Citations in the text are to the sections of the act and are not footnoted; Appendix B contains a conversion chart to help locate the correlative section of the U.S. Code. The SEC's rules are found in Part 17 of the Code of Federal Regulations. Rules under the 1933 Act are found in 17 C.F.R. §§ 230.100–904 (1993) and are numbered from 100 to 904. The 1934 Act rules are found in 17 C.F.R. §§ 240.01–31.1 (1993) and are numbered according to the section of the Act (e.g., Rule 10b-5 is promulgated under section 10(b)).

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The Federal Securities Laws and the SEC

The Federal Securities Laws

Shortly after the Wall Street crash of 1929, Congress entered into the securities regulatory arena with the Securities Act of 1933. When Franklin Roosevelt signed that act into law, he announced that securities law was to be changed from a system of *caveat emptor* to one of *caveat vendor*. As such, the Securities Act was the first federal consumer protection statute relating to securities.[1] Currently, there are seven statutes enacted in this area: the Securities Act of 1933[2] (referred to alternatively as the "1933 Act" and the "Securities Act"), the Securities Exchange Act of 1934[3] (referred to alternatively as the "1934 Act" and the "Exchange Act"), the Public Utility Holding Company Act of 1935,[4] the Trust Indenture Act of 1939,[5] the Investment Company Act of 1940,[6] the Investment Advisers Act of 1940,[7] and the Securities Investor Protection Act of 1970.[8]

At the time of enactment, the 1933 Act was administered by the Federal Trade Commission (FTC). The Act was, and still is, directed primarily at public offerings of securities. Subject to certain exemptions, the Securities Act of 1933 requires the registration of all securities being placed in the hands of the public for the first time. Many states had already adopted their own securities laws (so-called "blue sky" laws) which contained a merit approach, under which the state securities commissioner could examine the merits of the investment and then decide if the securities were suitable for a public offering. After considerable debate, Congress decided not to adopt the merit regulatory approach of the state acts, opting instead for a system of full disclosure. The theory behind the federal regulatory framework is that investors are adequately protected if all aspects of the securities being marketed are fully and fairly disclosed, leaving no need for the more time-consuming merit analysis. The Securities Act of 1933 contains a number of private remedies for investors who are injured because of violations of the

1. S. Rep. No. 47, 73d Cong., 1st Sess. 6–7 (1933).
2. 15 U.S.C. §§ 77a–77z (1988 & Supp. 1990).
3. 15 U.S.C. §§ 78a–78*ll* (1988 & Supp. 1990).
4. 15 U.S.C. §§ 79 to 79z-6 (1988 & Supp. 1990).
5. 15 U.S.C. §§ 77aaa–77bbbb (1988 & Supp. 1990).
6. 15 U.S.C. §§ 80a-1 to 80a-64 (1988 & Supp. 1990).
7. 15 U.S.C. §§ 80b-1 to 80b-21 (1988 & Supp. 1990).
8. 15 U.S.C. §§ 78aaa–78*lll* (1988).

Act. There are also antifraud provisions which bar material omissions and misrepresentations in connection with the sale of securities. However, the scope of the Securities Act of 1933 is limited. The 1933 Act covers only distributions of securities (both primary and secondary), whereas the Securities Exchange Act of 1934 addresses all types of securities transactions. Additionally, the 1933 Act's investor protection extends only to purchasers (not sellers) of securities.[9]

Unsatisfied with the relatively limited regulation provided by the 1933 Act, Congress enacted the Securities Exchange Act of 1934, extending further regulation over a wider range of participants and transactions in the securities industry. Since the 1934 Act greatly increased the required administrative responsibility, Congress relieved the FTC of its duties in this area and established the Securities and Exchange Commission (SEC, also referred to as "the Commission").[10] The Exchange Act of 1934 regulates all aspects of public trading of securities. It covers sellers as well as purchasers of securities, and imposes disclosure, reporting, and other duties on publicly held corporations. The Exchange Act also deals with such areas as stock manipulation, insider trading, manipulative or deceptive devices or contrivances in connection with the purchase or sale of stock, misstatements in documents filed with the SEC, and a myriad of other actions affecting securities sales, sellers, and purchasers. The Securities Exchange Act was substantially amended in 1975, largely to increase the SEC's authority over national securities exchanges and the structure of the market system.

The Public Utility Holding Company Act of 1935 was enacted to correct abuses in financing and operating public utilities. The SEC's functions in this area are largely finished; activities under the Holding Company Act currently constitute a very small part of the SEC's work.

The Trust Indenture Act of 1939 deals with debt financing of public issue companies in excess of a specified amount (currently $5 million). This Act imposes standards of independence and responsibility on the indenture trustee for the protection of the security holders.

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9. As discussed more fully in subsequent sections, the 1933 Act imposes disclosure obligations and other restrictions on sellers but not on purchasers of securities. The Act has this focus, since it was aimed at the distribution process. In contrast, the 1934 Act, which addresses transactions generally, imposes obligations on purchasers as well as sellers.

10. *See generally* SEC, A Twenty-Five Year Summary of the Activities of the Securities and Exchange Commission 1934–1959 (1961); Joel Seligman, The Transformation of Wall Street—A History of the Securities and Exchange Commission and Modern Corporate Finance (1982).

The Investment Company Act of 1940 regulates publicly owned companies that are engaged primarily in the business of investing and trading in securities. The Investment Company Act regulates investment company management composition, capital structure, advisory contracts, and investment policy modifications, and it requires SEC approval for transactions by such companies with directors, officers, or affiliates. The Act was amended in 1970 to impose additional controls on management compensation and sales charges. The Act also subjects investment companies to the disclosure requirements of the 1933 Act when offering their securities publicly, and the reporting, proxy solicitation, and insider-trading provisions of the 1934 Act.

The Investment Advisers Act of 1940, as amended in 1960, established a scheme of registration and regulation of investment advisers comparable to that in section 15 of the 1934 Act with respect to broker–dealers (discussed in detail later).

The Securities Investor Protection Act of 1970 established the Securities Investor Protection Corporation (SIPC) to aid securities firms in financial difficulty. The SIPC is involved in insolvent firms' liquidation and payment of claims asserted by customers. The SIPC is funded by monetary assessments on its members and a $1 billion line of credit from the U.S. Treasury. If the SIPC determines that a member firm is in danger of failing, it may apply to a court both for a decree that the firm's customers need the protection of the Act and for the appointment of a trustee to liquidate the firm. If the firm's assets are insufficient to pay all legitimate customer claims, the SIPC must advance to the trustee sufficient funds to satisfy all such claims up to a maximum of $100,000 for each customer (but with respect to claims for cash, not more than $40,000).

The Securities and Exchange Commission

The one common thread running through the federal securities laws is that they are administered by the SEC.

The SEC is a true "superagency" and exercises most administrative powers, with one exception: It does not adjudicate disputes between private parties. In contrast, the Commodity Futures Trading Commission (CFTC) can resolve customer complaints through reparations proceedings based on brokers' violations of the Commodity Exchange Act or CFTC regulations.[11] There was no cease and desist authority until October 1990, when the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 gave the SEC such authority. The SEC will be promulgating rules governing the exercise of this authority.

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11. 7 U.S.C. § 18 (1988).

Section 4 of the 1934 Exchange Act provides that the SEC have five commissioners—no more than three of whom can be from the same political party. The main SEC office is located in Washington, D.C., and is composed of a number of divisions.[12] There are nine regional offices throughout the country.[13]

The SEC's role in administering the securities laws takes two basic forms: direct SEC regulation through rules, orders, and enforcement; and an elaborate system of industry self-regulation carried out under SEC supervision and oversight. The self-regulatory organizations (SROs) include the securities exchanges, such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and the Municipal Securities Rulemaking Board, which establishes rules governing municipal securities dealers. Self-regulatory organizations have their own membership criteria, rules of operation, and disciplinary procedures, all of which are subject to SEC review.

Much of the SEC's rule-making power derives from sections of the securities laws which specifically empower the SEC to promulgate rules that

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12. Those divisions are (1) Corporation Finance ("Corp. Fin."), with primary responsibility for examining all registration documents for compliance with the disclosure requirements of the securities laws and preparation of disclosure guides promulgated by the agency; (2) Enforcement, responsible for the investigation of all suspected securities laws violations; (3) Market Regulation, which oversees regulatory practices and policies relating to the exchanges, the over-the-counter markets, and broker-dealers; (4) Investment Management, which administers the Investment Company and Investment Advisers Acts of 1940 and the Public Utility Holding Company Act of 1935; (5) Office of the General Counsel; and (6) Office of Economic Analysis (since the mid-1980s, the chief economist and his staff have had an increased role in formulating Commission policy). Most lawyers contacting the SEC deal with staff members who give informal advice.

13. Region 1—New York (covering New York and New Jersey); Region 2—Boston (covering Connecticut, Massachusetts, Rhode Island, New Hampshire, and Vermont); Region 3—Atlanta (covering Alabama, Florida, Georgia, Eastern Louisiana, Mississippi, North Carolina, Puerto Rico, South Carolina, Tennessee, and the Virgin Islands); Region 4—Chicago (covering Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Ohio, and Wisconsin); Region 5—Fort Worth (covering Arkansas, Kansas, Western Louisiana, Oklahoma, and Texas; Region 5 has a branch office in Houston); Region 6—Denver (covering Colorado, Nebraska, New Mexico, North Dakota, South Dakota, Utah, and Wyoming; Region 6 has a branch office in Salt Lake City); Region 7—Los Angeles (covering Arizona, California, Guam, Hawaii, and Nevada; Region 7 has a branch office in San Francisco); Region 8—Seattle (covering Alaska, Idaho, Montana, Oregon, and Washington); Region 9—Philadelphia (covering Delaware, the District of Columbia, Maryland, Pennsylvania, Virginia, and West Virginia).

have the force of statutory provisions. Rule making by direct legislative delegation necessarily has the effect of law so long as it is carried out within statutory parameters. The SEC has also promulgated a number of interpretive or "safe-harbor" rules designed to aid corporate planners and attorneys in complying with the statutes' requirements. Unlike the rules promulgated pursuant to statutory delegation, interpretive rules do not carry with them the force of law.

Supplementing the SEC's rules are its forms for the various statements and reports which issuers, broker–dealers, and others are required to file under the securities laws. Since disclosure is such an integral part of the regulatory scheme, these forms (which have the legal force of administrative rules) play an important part in defining the extent of disclosure obligations. SEC Regulations S-K and S-X provide detailed guides for disclosure.

The SEC also engages in a substantial amount of "informal rule making" by setting forth its views on questions of current concern, but not as legal requirements imposed pursuant to formal procedures mandated by the Administrative Procedure Act. The SEC disseminates unsolicited advisory opinions in the form of "releases," which may include guidelines or suggested interpretation of statutory provisions and rules. These releases necessarily provide less precedential and predictive value than rules promulgated under the more formal interpretative rule-making process. One step below interpretive releases are the Commission's "no action" letters. These are responses to private requests from individuals, entities, or their attorneys seeking an indication of whether certain contemplated conduct is in compliance with statutory provisions and rules. "No action" responses take the form of recommendations from SEC staff members that the Commission take no enforcement action. Although technically not bound by a staff member's "no action" response, the Commission will almost invariably follow it.

Sources of Litigation

The judicial case law emanates from several types of proceedings. The SEC itself may proceed by initiating a civil action in federal court if it discovers what it believes to be a violation of the law. This is in addition to the SEC's administrative proceedings, which are discussed elsewhere.

Also, as discussed below, in many instances private parties will be able to bring suit under the federal securities laws. If the alleged violator is a broker–dealer or investment adviser required to register with the SEC, the Commission may initiate an administrative proceeding to revoke or suspend the firm's registration or take other disciplinary action. If the alleged violator is an issuer seeking to sell securities under a 1933 Act registration statement, the Commission can initiate administrative proceedings to suspend the effectiveness of the statement. In either case, the hearing is first held within

the Commission, with the SEC making the final decision after initial findings by an administrative law judge. Decisions can be appealed to the U.S. Court of Appeals in the District of Columbia or in the circuit where the registrant's principal place of business is located. In 1990, Congress added cease and desist powers to the SEC's enforcement arsenal.

If the alleged violator is an issuer not currently making a registered offering, or a person not registered with the Commission at all, the Commission must go to court to obtain relief. The SEC may seek an injunction against future violations and, in particularly egregious situations, may refer the matter to the Department of Justice for prosecution as a criminal violation of the securities laws.

Self-Regulation

Section 15A of the 1934 Act provides for registration of national securities associations. The National Association of Securities Dealers (NASD) is the largest of the self-regulatory organizations subject to SEC oversight. The SEC Division of Market Regulation oversees the self-regulatory organizations. In addition to the NASD,[14] there are nine self-regulatory organizations that are registered securities exchanges under section 6 of the 1934 Act.[15] The exchanges have listing requirements for securities, and the NASD has similar listing requirements for its national market system.

The NASD is the only registered securities association for broker–dealers effectuating transactions in private-sector securities. Section 15B of the 1934 Act addresses the regulation of municipal securities (i.e., state and municipal government obligations). Section 15B sets forth the authority for the Municipal Securities Rulemaking Board, which is the self-regulatory organization for municipal securities dealers. Section 15C deals with government securities dealers. Government securities are those issued by the federal government or a federal agency. Section 6 of the 1934 Act provides for the registration of national securities exchanges. As is the case with the NASD, all exchange rules, procedures, and disciplinary sanctions are subject to SEC oversight and review. Section 11 of the 1934 Act regulates exchange trading. Section 11A deals with the national market system. Section 17A of the 1934 Act addresses registration of clearing agents and stock transfer agents. Sections 7 and 8 implement margin regulations governing the extension of

14. The NASD is registered under § 15A, as described *supra*.

15. They are the New York Stock Exchange, American Stock Exchange, Chicago Board Options Exchange, Midwest Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, Boston Stock Exchange, Cincinnati Stock Exchange, and the Intermountain Stock Exchange. The Intermountain Stock Exchange, in Spokane, Wash., closed in 1991.

credit using securities as collateral. The margin rules are set by the Federal Reserve Board but are enforced by the SEC (and the self-regulatory organizations).

SEC Regulation

Section 15(a) of the Exchange Act of 1934 provides that broker–dealers (other than those conducting their business on a totally intrastate basis) must register with the SEC. Registration entails an initial disclosure document plus periodic reporting. The SEC registration subjects broker–dealers to SEC adjudicatory proceedings for imposition of disciplinary sanctions. Section 15(b)(8) makes it unlawful for any registered broker–dealer to engage in business unless the broker–dealer is a member of a national securities association or effects transactions solely on a national exchange on which it is a member. The NASD and exchange membership requirements, rules, market surveillance, and disciplinary procedures are all subject to SEC oversight and review.

Private Remedies

Persons who believe themselves to be injured by a violation of the securities laws can bring a civil action for damages. A number of sections of the 1933 and 1934 Acts provide for an express private right of action. Perhaps the most significant civil liability exists under various "implied" rights of action under provisions prohibiting the activity in question.

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Scope and Reach of the Securities Laws

Definition of *Security*

The federal securities laws provide jurisdiction, of course, over securities. But what is the definition of *security*? The term has been broadly defined by the statutes; section 2(1) of the Securities Act of 1933 is representative:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The administrative and judicial definition of security has developed primarily from the interpretation of the statutory phrase "investment contract." In struggling for an appropriate definition, courts have always been mindful that the bottom-line issue is whether the particular investment or instrument involved needs or demands the investor protection of the federal securities laws.[16]

The landmark case on the definition of investment contract is *SEC v. W.J. Howey Co.*[17] Under the test developed in that case, a contract, transaction, or scheme is an investment contract if "a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party."[18] Subsequently, the requirement that profits be secured "solely" from the efforts of others has been diluted so

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16. Marine Bank v. Weaver, 455 U.S. 551 (1982) (bank-issued certificate of deposit not a security subject to federal securities laws, since it is already federally insured and purchasers therefore do not need that extra layer of protection the laws afford).

17. 328 U.S. 293 (1946).

18. *Id.* at 298–99.

that the profits must come "primarily" or "substantially" from the efforts of others.[19] In determining if this test is satisfied, the focus is on the "economic reality" surrounding the investment package as a whole, not exclusively on any single factor. For example, in *Howey*, the defendants claimed that what were being sold were orange trees. There was also an "optional" service agreement that could be purchased, whereby the promoters would handle all management of trees bought by the investor. The realities of the situation, however, revealed that what was being sold was a security interest in the trees and their fruit. Buyers were not expected to come to the field and tend their own trees; in fact, that would have been nearly impossible. Based on the small size of the plots, only a common enterprise and the resultant economies of scale would make the plots economically feasible. Moreover, there was no physical access or right of access to the individual plots—as such, it was virtually impossible for any single buyer to manage his or her plot individually, or even use a competitor's services. Thus, although not tied by contract, as an economic reality the services offered by the promoters were tied to the property, creating a security.

Of course, the definition of security is not limited to investment contracts. For example, *stock* is explicitly included in the statutory definition. There is a strong presumption that stock is a security. Nevertheless, under the "economic reality" test, it has been held that some transfers of instruments called stock are *not* transfers of securities. In *United Housing Foundation, Inc. v. Forman*,[20] the Supreme Court rejected the argument that merely denominating an interest as stock necessarily makes it a security. In that case, the stock was stock in a government-subsidized residential housing cooperative. Sale of the stock was tied to leasing an apartment in the cooperative. An examination of the stock showed that it yielded no dividends, provided no rights to appreciation, and was nontransferable. Furthermore, the voting rights were not set by number of shares of stock held but by the leasehold interest held. The Court, placing substance over form, focused on the economic reality of the venture and found that the shares of stock did not fall within the Securities Act's definition.

Following this "economic reality" approach, many circuits recognized a "sale of business" exception to treating stock as a security: Namely, when an entire business (or in some cases, a "controlling interest" in a business) was sold, the transfer of stock was merely an "incident" of the business and thus

19. *See, e.g.*, SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (pyramid sales arrangement is a security).
20. 421 U.S. 837 (1975).

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did not fall under the Securities Act.[21] When the Supreme Court faced the issue, however, it took a literal approach: Finding that the stock involved had all the incidents of "stock," it held that even the sale of all the stock of a company is a sale of securities subject to securities laws.[22]

The impact of the demise of the "sale of business" doctrine transcends the sale of closely held businesses. The decision rejects the application of *Howey* as the exclusive test of what is a security. The *Howey* test is still good law with regard to investment contracts, but other investment instruments, such as stock and notes which are expressly included in the statute, are analyzed differently. Stock, notes, and other specifically included investment vehicles are presumptively considered to be securities, but the presumption can be overcome.

Both the 1933 and 1934 Acts provide that "any note" is a security. However, both the statutes themselves and the courts have modified the phrase so that it is not read literally. Special provisions deal with the applicability of the federal securities laws to short-term notes. Section 3(a)(3) of the Securities Act of 1933 *exempts* from registration (but not from liability imposed by antifraud provisions of the Act) any "note . . . aris[ing] out of a current transaction" with a maturity not exceeding nine months.[23] In contrast, section 3(a)(10) of the Securities Exchange Act of 1934 *excludes* (even from the antifraud provisions) such notes from the definition of security. In *Reves v. Ernst & Young*, the Supreme Court declared that the phrase "any note" "must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."[24] In this case, the Supreme Court adopted the "family resemblance" test for determining whether or not a note is a security. Using this approach, the starting point is

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21. *See, e.g.*, Christy v. Cambron, 710 F.2d 669 (10th Cir. 1983); King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). *See generally* Thomas Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C. L. Rev. 393 (1983); Irving Seldin, *When Stock Is Not a Security: The Sale of Business Doctrine Under the Federal Securities Laws*, 37 Bus. Law. 637 (1982).

22. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). *See generally* John O'Brien & John Moye, *The Sale of Business Doctrine:* Landreth *Adds New Life to the Anti-Fraud Provisions of the Securities Acts*, 11 Vt. L. Rev. 1 (1986).

There is still some question as to whether the sale of business doctrine can be used under state securities laws to find the absence of a security. *Compare* Jabend, Inc. by Aebig v. Four-Phase Sys., Inc., 631 F. Supp. 1339, 1345 (W.D. Wash. 1986) (indicating that the doctrine may be applicable under California law) *with* Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520 (D. Minn. 1986) (rejecting the doctrine).

23. The Act further exempts all renewals thereof that are "likewise limited."

24. 494 U.S. 56, 63 (1990).

a rebuttable presumption that the note is a security. Based on a number of factors, the courts have created a list of instruments that, although they are "notes," do not fall within the definition of security.[25] The presumption that a note is a security may be rebutted by showing that the note in question fits in a category on the list, bears a strong "family resemblance" to a category on the list, or belongs to another category that should be on the list.

The Supreme Court in *Reves* set out the factors to be considered in determining whether a note is a "security": (1) the motivations/expectations of the parties involved in the note transaction; (2) the investment or commercial nature of the transaction; (3) the reasonable expectations of the public; and (4) the existence or nonexistence of other regulatory schemes to control the transaction.[26] These four factors incorporated the early "commercial v. investment" approach,[27] which rested on the view that many transactions regulated in more specific ways do not need the protection of the federal securities laws.[28] The *Reves* approach further incorporates other considerations to assure that only notes which resemble the type of securities transactions the acts were designed to regulate are included in the definition of "note."

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25. *See, e.g.*, Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1137 (2d Cir. 1976).

26. The Court described the factors:

> If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Reves v. Ernst & Young, 494 U.S. 56, 66–67 (1990) (citations omitted).

27. *See, e.g.*, Smith Int'l, Inc. v. Texas Commerce Bank, 844 F.2d 52 (5th Cir. 1988); Union Nat'l Bank v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986).

28. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551 (1982) (federally insured certificate of deposit issued by bank not subject to securities laws); Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281 (D. Mass. 1983); Tafflin v. Levitt, 865 F.2d 595 (4th Cir. 1989), *aff'd*, 493 U.S. 455 (1990) (certificate of deposit issued by savings and loan association not a security).

Jurisdictional Provisions

The Securities Act of 1933 and Exchange Act of 1934 have different jurisdictional reach. The 1934 Act governs offerings or issuers with sufficient interstate contact to support federal regulation.[29] In contrast, section 5 of the 1933 Act asserts jurisdiction requiring registration for nonexempt offers or sales of securities through an instrumentality of interstate commerce. Although jurisdiction would otherwise exist, there is an exemption from registration for offerings taking place within a single state.[30]

The federal courts have taken a broad view of the jurisdictional reach of the securities antifraud provisions. These provisions generally apply to all securities, whether or not they are exempt from registration and periodic reporting requirements. Typically, these provisions are triggered by the use of an instrumentality of interstate commerce.[31] Since the courts have tended to view the jurisdiction so conveyed as expansive, even a face-to-face conversation may be subject to the broadest antifraud provision—SEC Rule 10b-5—if the conversation is part of a transaction that utilizes some instrumentality of interstate commerce.[32] It appears to be the majority rule that it is not necessary that the misrepresentation be communicated through an instrumentality of interstate commerce so long as there is a connection be-

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29. As to offerings, § 12(a) makes it unlawful for any broker or dealer to effect any transaction in a security on a national exchange unless a 1934 Act registration has been effected for the security. The registration requirement is set forth in § 12(g). *See* Donald Scott, *Checklist for Registration of Securities Under Section 12(g) of the Securities Exchange Act of 1934*, 25 Bus. Law. 1631 (1970).

As to issuers, for example, all issuers having more than $5 million in assets and 500 or more holders of a class of equity securities, and issuers having issued securities under a 1933 Act registration statement with more than 300 holders of such securities are subject to 1934 Act requirements. Sections 12(a),(g), and 15(d).

30. Section 3(a)(11) of the 1933 Act.

31. *E.g.*, 1933 Act § 12 (rendering unlawful offers and sales "mak[ing] use of any means or instrumentality of transportation or communication in interstate commerce or of the mails to sell such security" unless the security is registered or exempt); 1934 Act § 10(b) ("by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange").

32. *E.g.*, Franklin Sav. Bank v. Levy, 551 F.2d 521, 524 (2d Cir. 1977) (jurisdiction found for claim based on § 12(2) of the 1933 Act; "the sales here consisted primarily of the manual delivery of the note and the receipt of payment, neither of which occasioned the use of the mails. After delivery of the note and receipt of the payment, however, [defendant] mailed a letter to [plaintiff] confirming the sale"); Leitner v. Kuntz, 655 F. Supp. 725 (D. Utah 1987) (mailing of financial statement plus use of telephone to change date of face-to-face meeting were sufficient for jurisdictional purposes).

tween the use of the jurisdictional means and the fraud.[33] A broad reading of the securities laws' jurisdictional requirements appears further warranted by a recent Supreme Court decision involving federal mail and wire fraud.[34]

The jurisdictional scope of the regulatory provisions of the 1934 Act varies. A few 1934 Act provisions apply only to exchange-listed securities and not to over-the-counter securities.[35] For example, section 9 of the 1934 Act prohibits manipulative activity only in connection with securities that are traded on a national securities exchange.[36] In contrast, however, section 15(c) of the 1934 Act gives the SEC the power to promulgate rules prohibiting brokers and dealers from participating in manipulative, deceptive, or fraudulent acts or practices in connection with sales, or attempts to induce sales, and is not limited to securities traded on the registered national exchanges.

SEC Enforcement Powers

The SEC is empowered to investigate suspected violations of the securities laws. Most investigations are conducted with a view toward (1) initiation of SEC judicial proceedings—leading to injunctive and/or ancillary relief; (2) initiation of SEC administrative proceedings—leading to sanctions for market professionals; or (3) referral to the Justice Department for criminal prosecution. In addition to the normal investigation, which may lead to criminal prosecution, civil litigation, or administrative action under section

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33. *E.g.*, Kline v. Henrie, 679 F. Supp. 464 (M.D. Pa. 1988); United States v. Pray, 452 F. Supp. 788 (M.D. Pa. 1978); Harrison v. Equitable Life Assurance Soc'y, 435 F. Supp. 281 (W.D. Mich. 1977); Levin v. Marder, 343 F. Supp. 1050 (W.D. Pa. 1972).

34. Carpenter v. United States, 484 U.S. 19 (1987). The court found a violation of the mail fraud statute where the defendants did not themselves use the requisite instrumentality but the scheme was dependent on someone else using the mail. The defendants were convicted of trading on advance knowledge of columns that were to appear in the *Wall Street Journal*; the mailing of the *Journal* was held to satisfy the jurisdictional means. This expansive interpretation is consistent with the broad interpretation that the federal courts have given to the securities laws generally.

35. See 1934 Act § 9's antimanipulation provisions but note that under § 15c there is regulation of over-the-counter manipulation.

36. The New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) are the major national exchanges for stock. Although it may operate much like an exchange, the National Association of Securities Dealers' National Market System is not a registered national securities exchange; the securities traded using the National Association of Securities Dealers' Automated Quotation System (NASDAQ) are considered over-the-counter securities and are not subject to § 9 prohibitions.

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21(a) of the 1934 Act, the SEC is empowered to issue public reports of its findings. This power is relatively rarely invoked and has raised considerable controversy.[37]

As noted above, the SEC has the power to go to court to enforce the 1934 Act. Note that the SEC may only perform its direct prosecutorial function in civil suits for injunctions and ancillary relief against alleged violators. Should a criminal violation exist, the SEC Division of Enforcement refers it to the Department of Justice for criminal prosecution. Where appropriate, the SEC may choose to address a securities law violation with administrative sanctions. With regard to market professionals (broker-dealers, investment bankers, investment companies, and investment advisers), the SEC can initiate adjudicatory proceedings that lead to possible sanctions ranging from censure to suspension or revocation of the right to act as a securities professional. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 gave the SEC cease and desist power. A cease and desist order may be appealed to the full Commission or directly to a federal court.[38] The 1990 legislation also added section 21(d)(2) to the 1934 Act (and parallel provisions of the other securities laws), which empowers the Commission to obtain a court order barring a person from serving as an officer or director if his or her conduct demonstrates "substantial unfitness." The 1990 legislation also gave the SEC power to issue civil penalties and, in administrative proceedings, require disgorgement of ill-gotten profits resulting from securities law violations. It requires additional disclosures by dealers in certain low-priced stocks, frequently referred to as penny stocks.[39]

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37. For an example of criticism of the publication of investigations, see *In re* Spartek, Inc., 491 Exchange Act Release No. 34-15567 (SEC Feb. 14, 1979) (Karmel, dissenting).

38. The Commission is likely to promulgate rules governing the cease and desist authority and procedures therefor.

39. The SEC penny stock rules apply to equity securities priced under $5 per share that are not traded on a national exchange or through an automated quotation system. Additional disclosures are now required about both the market value of these stocks and the people selling the stocks. Furthermore, the SEC is directed to adopt rules limiting the use of proceeds of penny stock sales, providing a right of rescission to purchasers, and facilitating development of a quotation system providing volume and last sale information. See also Rules 15g-1 through 15g-8, which contain the SEC's penny stock rules. These rules replaced Rule 15c2-6, an antifraud provision designed to combat the "unscrupulous, high pressure sales tactics of certain broker-dealers by imposing objective and readily reviewable requirements that condition the process by which new customers are induced to purchase low-priced stocks." Exchange Act Release No. 27,160 (Aug. 22, 1989).

The SEC does not have jurisdiction to adjudicate disputes between private parties.[40] However, as mentioned above, it has the power to order disgorgement of profits in administrative proceedings and has adjudicatory responsibility with regard to regulation of market professionals.[41]

Relation to Other Laws

In addition to the seven federal securities acts previously discussed, a number of related laws affect securities and securities regulation. The SEC is involved in the administration of some of these related laws.

For certain regulated industries, the securities of issuers may be subject to other federal administrative agencies.[42] While for some situations there is a need for additional securities regulation by the SEC, in many other situations the federal securities laws create an exemption for such securities and/or issuers. The rationale for these exemptions is that the regulation provided by the other agencies is more subject-specific, and it may be time-consuming and wasteful to "double regulate" in these areas. For example, the Comptroller of the Currency has jurisdiction over the distribution of securities issued by national banks,[43] although securities issued by bank holding companies are subject to SEC jurisdiction. A similar arrangement exists with regard to securities of savings and loan associations, which are subject to regulation by the Federal Home Loan Bank Board.[44] Other examples include securities of common carriers, regulated by the Interstate Commerce Commission, and securities of eleemosynary organizations, governed by regulations of the Internal Revenue Service.

For securities and issuers that are subject to SEC regulation, a number of related statutes may come into play to supplement the federal securities laws. The Foreign Corrupt Practices Act of 1977[45] was enacted in response to widespread concern over the activities of domestic companies in their deal-

40. *Cf.* the CFTC's reparations proceedings. Commodity Exchange Act § 14, 7 U.S.C. § 18 (1988).

41. Pursuant to Rule 2(e) of its Rules of Practice, the Commission can institute proceedings to suspend or otherwise discipline individuals admitted to practice before the Commission. The rule has been used on several occasions against lawyers and accountants. Formerly these were nonpublic proceedings, but as a result of a rule amendment, proceedings are now public unless the Commission orders otherwise.

42. *See* Harry Henn & John Alexander, Laws of Corporations § 304 (3d ed. 1983).

43. 12 U.S.C. §§ 51–51c (1988); see also the 1933 Act § 3(a)(2), which provides an exemption from registration.

44. 12 U.S.C. §§ 1461–1470 (1988 & Supp. 1990); see also the 1933 Act § 3(a)(5), which provides an exemption from registration.

45. 15 U.S.C. §§ 78m(b)(2), 78dd-1, 78dd-2 (1988).

ings abroad. The Racketeer Influenced and Corrupt Organizations Act (RICO) was enacted to facilitate efficient law enforcement with regard to organized crime and racketeering activities. Under RICO, suits may be criminal or civil in nature, and in civil actions, violations result in the award of treble damages. The federal Mail Fraud and Wire Fraud Acts[46] are also important weapons in securities regulation.[47]

The regulation of commodities futures and commodities options is subject to jurisdictional disputes. The futures market is directly regulated by the Commodities Futures Trading Commission (CFTC),[48] but the SEC regulates options markets (which have investment goals similar to those of commodities futures contracts). Another area of regulation causing conflict between the CFTC and SEC has been the development of new investment products, such as financial futures, which are traded in the commodities markets, and financial index options, which are traded in the securities markets.

A major issue in securities regulation has been the increasing competition between banking and more traditional participants in the securities industry. Although the Glass-Steagall Act of 1933[49] prohibits commercial and savings banks from engaging in various aspects of investment banking, the line between investment and commercial banking has been eroded. Developing competition between commercial and investment banking is manifest not only by each offering competing services but also by banks' acquisitions of stock brokerage operations and vice versa. As a result of the recent savings and loan crisis, regulation may return to this area. Over the past two decades, the SEC and various bank regulatory agencies, including the Comptroller of the Currency, have been involved in various jurisdictional disputes.

46. 18 U.S.C. §§ 1341, 1343 (1988 & Supp. 1990).

47. For example, while the Supreme Court was equally divided over criminal convictions under the securities laws for trading on confidential information, the Court was unanimous that the conduct violated the Mail Fraud Act. Carpenter v. United States, 484 U.S. 19 (1987).

48. 7 U.S.C. §§ 1–25 (1988 & Supp. 1990). *See generally* Philip Johnson & Thomas Hazen, Commodities Regulation (2d ed. 1989).

49. The Banking Act of 1933, ch. 89, 48 Stat. 184 (1933) (codified in various sections of 12 U.S.C.).

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Regulating the Distribution of Securities—The Securities Act of 1933

Structure of the 1933 Act

The Securities Act of 1933 regulates the distribution of securities. There are two basic ways that securities can be distributed. The first is by a primary offering (a primary distribution): Stock is sold from the issuer to the stockholder and is generally used as a method of raising capital. The second type is a secondary distribution: A major shareholder (or group of shareholders) sells his or her stock to someone else. In this case, the proceeds go not to the corporation (or other primary issuer), but to the selling shareholder. The 1933 Act regulates both primary and secondary distributors, since it covers distributions of securities by issuers, underwriters, and sellers.

When analyzing a transaction to determine if it is covered by the 1933 Act, and therefore requires registration as a precondition to offers and sales, there is a basic "road map" for working through the statute.[50] First, section 2(1) defines a security. If the interest or instrument in question is found to be a security, the analysis focuses on whether the security qualifies for one of the exemptions from registration found in section 3. Section 4 lists certain transactions that are exempt, even if the security itself does not fall under a section 3 category. If the security or transaction at issue does not fall under one of these two provisions, registration is required under section 5, which also provides offer and sale limitations. Sections 6 and 8 set forth the procedure for registration; sections 7 and 10 list the disclosure requirements. If any of these sections are violated, there are civil liabilities under sections 11 and 12. Additionally, there is a general antifraud provision regulating these transactions in section 17 of the Act, violation of which may result in SEC or criminal prosecution.

Registration Under the 1933 Act

Section 5 of the 1933 Securities Act breaks down the registration process into three periods. These periods are based on the filing and effective date of the registration statement, which generally will be prepared by a team of lawyers, accountants, issuer management, and underwriters.

The first is the "prefiling" period, starting months before the filing of the registration statement and lasting until the filing date. The second period,

50. While the following is not exhaustive, it provides a broad overview of the 1933 Act.

the "waiting" period, runs from the filing date until the effective date.[51] The last period, the "post-effective" period, begins at the effective date and is the first time that sales may take place.

Section 5 of the Act places various restrictions on the dissemination of information throughout the registration process.[52] A violation of section 5 depends on use of the jurisdictional means—an instrumentality of interstate commerce. Section 5 limits the type of selling efforts that may be used. The scope of permissible selling efforts and the type of information that may be disseminated varies depending on whether one is operating during the prefiling period, waiting period, or post-effective period. In general, sections 5(a)(1) and 5(a)(2) are in effect in the prefiling and waiting periods, but not during the post-effective period. Section 5(b)(1) is in effect in the waiting period and post-effective period, but not during the prefiling period. Section 5(b)(2) is in effect only in the post-effective period. Finally, section 5(c) is in effect only in the prefiling period.

Prefiling period. Section 5(c) of the Act prohibits all offers to sell and buy prior to the filing of the registration statement. An offer to sell is any communication reasonably calculated to generate a buying interest.[53] It applies to oral as well as written offers.

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51. The waiting period can be several months or longer. Pursuant to § 8 of the 1933 Act, the registration statement becomes effective twenty days from the date of the original filing or the filing of the most recent amendment, whichever is last. The twenty-day period is misleading in terms of actual practice. The waiting period is usually much longer than the statutory twenty days for first-time issuers and for complicated offerings because of SEC review practices. Under § 8, the effective date of deficient registration statements can be delayed by a stop order or refusal order. Formal § 8 orders are the exception, since the SEC will generally respond to deficient registration statements with a letter of comment suggesting changes. The letter of comment will frequently be followed by a delaying amendment filed by the prospective issuer, which will put off the effective date until the deficiencies are corrected. When appropriate, the effective date can be accelerated (see SEC Rule 461).

52. It is noteworthy that by virtue of §§ 4(1) and 4(4) of the 1933 Act, § 5 does not apply to persons other than issuers, underwriters, or dealers. Nor does it apply to unsolicited brokers' transactions.

53. See the SEC decision in Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843 (1959). This case is generally considered the leading precedent for determining the scope of the definition of offer to sell. In *Loeb*, the company at issue was planning to go public. It had made a preliminary agreement with a group of underwriters. The lead underwriter issued a press release providing many specific details about the forthcoming offering. The SEC, while recognizing that prefiling press releases may be a legitimate publicity device, ruled that this release was too explicit and was in fact designed to arouse buying interest, in violation of § 5(c). Subsequently, the SEC,

A large body of public information concerning securities is generated by broker–dealers, investment advisers, and other financial analysts. Balanced against the desire to prevent "gun jumping" as expressed by the prohibitions of section 5(c) is the underlying purpose of federal securities regulation: affirmative disclosure. Therefore, there are various exemptions from section 5(c)'s prohibitions in the prefiling period. For example, SEC Rules 137, 138, and 139 provide exemptions from gun-jumping prohibitions for certain broker–dealer recommendations in the case of securities of 1934 Act reporting companies.[54] These exemptions apply with equal force to the waiting and post-effective periods. These rules recognize the fact that many investment bankers have research analysts who are separate from the underwriting department. Accordingly, the rules permit the research department to continue with its regular business without violating the prohibitions of section 5 of the 1933 Act. These exemptions are conditioned on certain protections, including the requirements that the issuer of the recommended securities is sufficiently large and subject to the reporting requirements (which ensure that there is sufficient public information already available). At the same time, it is clear that any broker's or dealer's recommendation to purchase a security that does not fall within the parameters of these rules would clearly violate section 5 unless, of course, some other exemption could be found.

Section 2(3)'s definition of the terms *sale* and *offer to sell* excludes preliminary negotiations and agreements between the issuer and the underwriter, as well as among underwriters in privity with the issuer. This exclusion permits the formation of the underwriting agreement. However, generally only a letter of intent is signed at this stage; the final underwriting agreement is usually not executed until the eve of the offering. Although there may be prefiling activity designed to form the underwriting group, contacting too many potential underwriters or potential members of the retail "selling group" may be viewed as improperly preconditioning the market, and therefore may result in a finding of illegally jumping the gun. The purpose of the section 2(3) exclusion for underwriter negotiations and agreements is to balance the need for formation of the underwriting group against the desire not to have premature widespread generation of a buying interest.

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recognizing the informational tensions at issue, amended one of its rules to address prefiling publicity by an issuer. *See* SEC Rule 135. There remains a question as to whether Rule 135, which speaks only of *issuers* releasing information, is the exclusive list of permissible information or whether the rule is simply a safe harbor.

54. Sections 13 and 15(d) of the 1934 Act provide for periodic reporting of issuers whose securities are traded on a national exchange, securities that have been subject to a 1933 Act registration, or issuers with more than $3 million in assets and more than 500 holders of a class of equity securities.

Section 5(a) of the 1933 Act prohibits sales prior to the effective date and thus operates during both the prefiling and waiting periods. Section 5(a)(1) prohibits the sale (or confirmation of a sale) prior to the effective date; section 5(a)(2) prohibits taking steps toward the sale or delivery of securities pursuant to a sale through instrumentalities of interstate commerce prior to the effective date.

Waiting period. Section 5(c)'s prohibitions on offers to sell and buy no longer apply once the registration statement has been filed. However, section 5(a)'s prohibitions on sales continue through the waiting period. In addition, section 5(b) of the 1933 Act imposes prospectus requirements which have the effect of controlling the types of written offers to sell that may be made during both the waiting and post-effective periods. Section 5(b)(1) provides that any prospectus must meet the requirements of section 10 of the 1933 Act. Section 2(10) defines a *prospectus* as any written or other permanent or widely disseminated offer to sell. For example, a telephone communication is not a prospectus, but a television or radio advertisement is. A written confirmation of a sale is expressly included in the statutory definition of a prospectus.[55]

The combination of these statutory provisions results in a limited variety of permissible written offers to sell which may be used during the waiting period (and post-effective period as well). While section 5 permits offers during the waiting period, section 2(10) makes any offer in writing a prospectus, and section 5(b)(1) makes it unlawful to transmit any prospectus after the filing of the registration statement unless the prospectus contains the information called for by section 10. This information may not be available until the underwriting agreements have been signed and the offering price set. The Act solves this problem by exempting from this path two types of written offering material: the "tombstone ad" and the preliminary, or "red herring," prospectus. Both are discussed below.

Since section 5(c) does not apply during the waiting period, offers to buy are permissible. However, an offer to buy that leads to a premature or otherwise illegal sale will violate section 5(a).

By virtue of section 10(b) of the 1933 Act, which permits certain prospectuses during the waiting period, and section 2(10), which excludes certain communications from the definition of prospectus, there are four types of permissible waiting period offers to sell.

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55. Rule 10b-10 of the 1934 Act requires that all sales by broker–dealers be confirmed in writing.

First, all oral communications are permitted, provided that no sale is consummated (lest there be a violation of section 5(a)).[56] Since an oral communication is not "permanent," it is excluded from the section 2(10) definition of prospectus.

Second, an "identifying statement" (one variety of which is known as a "tombstone advertisement") as defined in section 2(10)(b) and Rule 134 is permissible during the waiting period. This is a relatively narrow category because the type of information that may be included is severely limited. Section 2(10)(b) expressly excludes these "communications" from the definition of "prospectus" as long as the requirements of Rule 134 are met. Inclusion of any information not specifically permitted by Rule 134 renders the rule unavailable and thus may result in a prospectus that fails to comply with section 10's requirements. This, in turn, can result in a violation of section 5.

Third, a preliminary (or "red herring") prospectus, as defined in Rule 430, is permissible during the waiting period. The preliminary prospectus must contain the information required in a full-blown statutory prospectus, except that price and some other terms may be omitted. Furthermore, there must be a legend explaining that it is a preliminary prospectus. This prospectus may be used only during the waiting period; it may not be used after the effective date.

Finally, a preliminary summary prospectus, as defined in Rule 431, which like the red herring prospectus is a section 10(b) prospectus, may be used by certain experienced issuers during the waiting period. The summary prospectus may also be used after the effective date and, like the preliminary version, is available only for an issuer who is a 1934 Act registered reporting company. The Rule 431 prospectus must contain all of the information specified in the official SEC form accompanying the applicable registration statement form as well as a caption stating that a more complete prospectus will be available from designated broker–dealers. The summary prospectus may not include any information not permitted in the registration statement or a tombstone ad as spelled out in Rule 134(a). A Rule 431 summary

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56. The only prohibition is on written offers to sell, thus any (including written) offers to buy are permissible, provided the sale is not consummated. Furthermore, while there are no § 5 implications, oral offers to sell are, of course, subject to the securities acts' general antifraud provisions.

prospectus only satisfies section 5(b)(1);[57] it does not satisfy section 5(b)(2).[58] Thus, when a Rule 431 summary prospectus is used, a "full-blown" (or "statutory") section 10(a) prospectus must still be delivered to all purchasers. This necessarily increases the record-keeping and monitoring activities of the underwriters.

Post-effective period. Once the registration statement becomes effective, section 5(a)'s prohibitions cease to apply and sales are permitted. Both of section 5(b)'s prospectus requirements apply. Subsection 1 requires that all written or otherwise permanent offers to sell or confirmations of sales must be qualifying prospectuses (i.e., a section 10(a) "full-blown" statutory prospectus or a qualifying section 10(b) prospectus). Section 5(b)(2) provides that no security may be delivered for sale unless accompanied or preceded by a statutory section 10(a) prospectus. In the case of securities held for a customer's account by a broker or other custodian, the customer must still receive the prospectus before delivery.

Under section 2(10), "free writing" is permitted in the post-effective period. Thus, supplemental sales information may be sent to prospective purchasers provided that it is preceded or accompanied by a prospectus that meets the requirements of section 10(a). In such a case, free writing is limited only by the antifraud provisions of the securities laws.[59]

Shelf registration (Rule 415). Originally, it was assumed that effective registration should mean that the covered shares were immediately on sale.[60] However, as offerings became more sophisticated, it became clear that there were offerings that should be delayed[61] or would be made on a continuous basis, making the existing registration system inadequate. Therefore, the SEC adopted Rule 415, permitting "shelf registration." Under this rule, a corporation that over a period of time has been eligible to use Form S-3 may register securities for sale from time to time over a period of up to two years. For the registration statement to remain effective, however, there is an ongoing duty to regularly update information in it.

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57. Section 5(b)(1) requires any written offer or confirmation to comply with § 10; a summary prospectus is valid for this purpose under § 10(b).

58. Section 5(b)(2), which applies only during the post-effective period, requires every person who purchases a security in the offering to receive a § 10(a) "full-blown" prospectus prior to delivery of that security.

59. Other rules to look at include Rules 137, 138, and 139, which deal with broker-dealer recommendations of securities during the registration process.

60. In fact, holding the shares off the market could be deemed a "manipulative" practice.

61. *E.g.*, debt offerings in times of fluctuating interest rates where the effective date may not fall in the best climate in which to attempt to sell the covered securities.

Exemptions from Registration Under the 1933 Act

Recall that section 5 of the 1933 Act applies to *any* offer or sale of *any* security unless an exemption exists. Exemptions may be based on the type of security involved (generally covered by section 3 of the 1933 Act)[62] or on the type of transaction (generally covered by section 4 of the Act and various SEC rules promulgated thereunder). The exemptions granted are exemptions from registration, *not* from the antifraud provisions.

The exemptions are to be strictly construed. The burden of establishing any exemption falls on the person claiming it. Because of the strict construction and burden of proof, transactions must be carefully structured and documented in order to be sure of securing an exemption. As a general proposition, a single violation in the course of a planned exempt transaction can destroy the entire exemption.[63] This is especially critical when one considers the dire consequences of losing an exemption (ranging from section 12(1) liability for rescission of any sale to possible criminal liability for the violator).

Exempt Securities

Section 3 of the 1933 Act is designed to provide exemptions from section 5 because of the nature of the security involved. For example, section 3(a)(2) exempts bank securities, insurance policies, and government securities. These securities are exempt because they are already regulated by some other agency more focused on the specific needs of the industry, and/or in general, the securities are considered less risky and thus investors need less protection.

Short-term commercial paper is exempt from registration under section 3(a)(3). This provision was enacted to exempt "short term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors."[64] While these, like other exempt securities, are subject to the 1933 Act's antifraud provisions, short-term commercial paper is excluded from the 1934 Act definition and thus is not subject to the 1934 Act's antifraud provisions. Virtually all other securities exempt from 1933 Act registration remain subject to the 1934 Act's antifraud provisions.

Securities of nonprofit issuers are exempt from registration under section 3(a)(4). Generally, availability of this exemption will depend on the ruling of

62. However, as discussed *infra*, §§ 3(a)(9), 3(a)(10), 3(a)(11), 3(b), and 3(c) operate more like transaction exemptions (i.e., later downstream resales may need a new exemption or else face registration).

63. But see SEC Rule 508, which provides that insignificant deviations from a term, condition, or requirement of Regulation D will not destroy the exemption for a transaction structured in good faith.

64. H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

the IRS regarding whether a contribution to the particular issuing institution is a proper charitable deduction. These issuers are exempt because they are already regulated and supervised by another agency. Section 3(a)(5) exempts securities issued by building and loan associations and similar associations, again because they are regulated more closely by another agency. Case law has narrowly defined this exemption: Substantially all of the issuer's business must entail making loans to its members.[65] Securities subject to ICC approval, a rather narrow category, are also exempt from 1933 Act registration by virtue of section 3(a)(6), again because they are already regulated by another agency. Another exemption of relatively narrow applicability is found in section 3(a)(7), exempting trustees' certificates issued in bankruptcy, provided they have been issued with court approval. The Congress saw little reason for securities law supervision of a receiver already under court supervision—beyond the antifraud provisions, of course.

Insurance policies and annuities are exempt from 1933 Act registration.[66] This provision does not exempt insurance company stock or other securities apart from such policies and annuities contracts. Further, certain annuity contracts (such as variable fund annuities) may *not* be exempt in light of the cases decided by the Supreme Court under the Act's definition of "security."[67]

The following section 3 exemptions, while labeled "security" exemptions, operate more like "transaction" exemptions when viewed functionally. Unlike other exempt securities, later transactions (after they have been issued) involving the same security will require a new exemption, although the nature of the security remains the same. In these instances what really provide the rationale for the exemptions are not the characteristics of the securities, but the characteristics of the offers.

Exemptions for Certain Securities Issued in Reorganizations

Certain voluntary exchanges between an issuer and its existing security holders are exempt from registration under section 3(a)(9), although this exemption is relatively narrow in scope. To qualify, no remuneration may be paid or given to any underwriter or any other person soliciting the exchange; the issuer of both the securities to be issued and the securities to be exchanged must be the same; and no part of the offering may be made to persons other than existing security holders. The rationale behind the section 3(a)(9) exemption is that as the offerees are already shareholders, and pre-

65. *See, e.g.*, SEC v. American Int'l Sav. and Loan Assn., 199 F. Supp. 341 (D. Md. 1961).

66. 1933 Act, § 3(a)(8).

67. *See, e.g.*, SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

sumably in possession of adequate information about the issuer, no new information need be given.

Judicially or administratively approved exchanges of securities are also exempt from 1933 Act registration by virtue of section 3(a)(10), again because the transaction is already supervised. As in the case of section 3(a)(9) exemptions for certain voluntary exchanges, although the provision is made under section 3, it is really more like a transaction exemption. Therefore, absent another exemption, all downstream public resales of securities by persons having acquired securities under this exemption must be registered.

The Intrastate Exemption

The section 3(a)(11) registration exemption for intrastate issues is also more properly characterized as a transaction exemption. Its availability depends not only on the attributes of the security or issuer but also on the form, scope, and extent of the transactions consummated pursuant to the offering. However, unlike most of the true transaction exemptions discussed below, there are no limitations on (1) the aggregate dollar amount of the securities to be offered; (2) the number or nature of offerees or purchasers so long as all offerees are residents of the state of the offering; (3) the manner of offering;[68] or (4) restrictions on resale so long as the securities have come to rest within the state.[69]

The intrastate exemption is relatively narrow: The entire offering must take place within a single state. The statutory provision is not drafted in a precise and detailed manner. Prior to 1974, persons relying on the exemption had relatively little judicial precedent and few SEC interpretive releases and rules available. Most guidance was found in SEC "no action" letters, which by their nature are expressly confined to the facts as given. Thus, in 1974, the SEC promulgated 1933 Act Rule 147 as a "safe harbor" rule in an attempt to provide certainty for those hoping to utilize this exemption.

Prior to the enactment of Rule 147, however, statutory construction made clear that certain requirements must be met for this exemption to be available. Section 3(a)(11) requires that the issuer be a resident of the state. If the issuer is a corporation, it must be incorporated under the laws of the state in addition to having its principal place of business there. The provision has been read so narrowly by the courts as to require the issuer not only

68. Note, however, that a general solicitation may trigger state securities law registration requirements.

69. As is the case with a transaction exemption, certain out-of-state downstream resales (i.e., before the securities have "come to rest") may destroy the intrastate exemption. *See* 1 Thomas Hazen, Treatise on the Law of Securities Regulation § 4.12 (2d ed. 1990).

to do business within the state but also to derive substantially all of its income from operations within the state and use substantially all of the proceeds of said income within the state.[70] The exemption expressly requires that all offerees be residents of the state. Furthermore, to retain the exemption, case law requires that the issue must "come to rest" in the hands of state residents.[71]

Even a limited number of nonresident resales before the issue has come to rest will render the exemption inapplicable to the entire offering.[72] In such a case, the resident purchasers will be able to claim that the securities they purchased were sold in violation of section 5, thus giving them a right of rescission under section 12(1) of the Act.[73] Whether or not the issue has "come to rest" within a single state is a highly fact-specific determination when there have been subsequent out-of-state resales. Certainly, time is a factor. The safe harbor rule, Rule 147, requires no resales to nonresidents until nine months from the date of the last sale by the issuer of a security of the type for which the exemption is sought. Of course, because this is only a safe harbor rule, nine months may not be necessary: The Tenth Circuit has held that resale to nonresidents within seven months of the initial offering did not violate the "coming to rest" requirement based on the facts of the case before it.[74] On the other hand, mere technical compliance with the safe harbor period of nine months is not sufficient if it is a sham merely to avoid registration. While certainly all purchasers will not be required to hold their securities for an infinite amount of time, the courts have shown that evidence of investment intent (or lack thereof) on the part of the resident purchasers is a relevant consideration.

Rule 147 is available only to issuers, although the statute is not so limited and could be applied to secondary transactions as well. In other respects, the safe harbor rule provides a good guideline to the elements of the statutory exemption. Its availability requires compliance with every element of the rule. The issuer must be a resident of and doing business within the state of the offering. If the issuer is a corporation, it must be incorporated in the state of the offering, and must make and use 80% of its profits within the state. All offerees and purchasers must be residents of the state of the offering. There are limitations on resales for a period of nine months after the last sale that is "part of the issue." "Part of an issue" is defined in subsection (b) of Rule 147 and is the rule's counterpart to the "integration doctrine" for

70. *See, e.g.*, SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D. Minn. 1972).

71. *See, e.g.*, Busch v. Carpenter, 827 F.2d 653 (10th Cir. 1987).

72. *See, e.g.*, Hillsborough Inv. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960).

73. Securities Act Release No. 33-4434 (Dec. 6, 1961).

74. Busch v. Carpenter, 827 F.2d 653, 657 (10th Cir. 1987).

telescoping multiple transactions into one. Rule 147 is only a safe harbor, and thus noncompliance raises no inference as to the unavailability of the exemption.

The Small Issue Exemptions

Section 3(b) of the 1933 Act empowers the SEC to provide additional small issues exemptions by promulgating appropriate rules. This section is not self-executing: It requires "enabling rules" developed and promulgated by the SEC. Thus, the SEC has the freedom to create the exemptions it believes necessary or appropriate in light of the agency's policy considerations. Currently, such exemptions are limited to offerings of $5 million or less. The exemptions emanating from this provision can be found in Regulation A, Regulation B, Rules 504 and 505 of Regulation D, Regulation F, and Rule 701. The SEC has proposed legislation that would raise section 3(b)'s ceiling to $10 million.

Section 3(c) of the 1933 Act authorizes the SEC to exempt securities issued by small business investment companies organized under the Small Business Investment Act of 1958, provided that enforcement of the 1933 Act "with respect to such securities is not necessary in the public interest and for the protection of investors." The Commission has exercised this power by promulgating Regulation E. By definition, the section 3(c) exemption is not available to the vast majority of public issuers of securities.

Exempt Transactions

Transactions Not Involving an Issuer, Underwriter, or Dealer—Section 4(1)

Section 4 of the 1933 Act describes the types of transactions that are exempt from the registration requirements of section 5. Transaction exemptions rise and fall with both the form and substance of the transaction and the nature of the participants. These exemptions, once available, can be destroyed when purchasers under the exemption resell the securities. Downstream sales have the potential to eradicate an existing exemption.

Section 4(1) provides a transaction exemption for persons other than an issuer, underwriter, or dealer. *Issuer* and *dealer* are defined in the 1933 Act[75] and have been interpreted as in ordinary parlance and not as terms of art. *Underwriter*, by contrast, has become a term of art subject to significant SEC and judicial construction.

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75. *Issuer* is defined in § 2(4) as "every person who issues or proposes to issue any security." *Dealer* is defined in § 2(12) as "any person who engages either for all or part of his time, directly or indirectly . . . in the business of offering, buying, selling, or otherwise dealing or trading in Securities issued by another person."

Section 2(11) of the 1933 Act defines an underwriter as

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . . As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Determining who is included in this definition has required substantial interpretation. Someone who is an essential cog in the distribution process is a statutory underwriter even if no remuneration is received.[76] It has been established that, by definition, underwriters include participants in relatively large transactions who may unwittingly become "underwriters" and thus subject to the proscriptions of section 5.[77] The Act's definition encompasses persons who purchase or otherwise obtain a large amount of securities directly from the issuer (or a control person) and then resell the securities.[78]

Initially, guidelines for the definition of underwriter arose from judicial and SEC interpretations. In determining whether a person is a statutory underwriter, a key question is whether the would-be underwriter had sufficient investment intent at the time of purchase (i.e., was an investor rather than an underwriter). In order to avoid underwriter status, purchasers frequently tried drafting letters of "investment intent" at the time of their purchase, but these letters were held only as evidence of intent and not determinative, especially when the stock was held for a short period of time.[79]

Despite case-by-case scrutiny, seemingly objective parameters began to appear. Determining investment intent has become in large part a question of how long the securities are held before resale. The consensus has been that holding the securities for two to three years or more is ordinarily sufficient to show investment intent.[80]

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76. *See, e.g.*, SEC v. Chinese Consol. Benevolent Assoc., 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941).

77. *See, e.g.*, Ira Haupt & Co., 23 S.E.C. 589 (1946).

78. *See, e.g.*, United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969) (defendant purchased the securities from the issuer); SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960) (defendant bank accepted stock as collateral, knowing there was a substantial likelihood that the loan recipient would default and bank would foreclose and sell the stock).

79. Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) (although investment letter existed, ten-month holding period was insufficient to show investment intent).

80. *See, e.g.*, United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959) (defendant held the stock for two years; this showed investment intent). *Cf., e.g.*,

However, passage of time alone may not be enough to prevent underwriter status. Section 2(11) speaks in terms of taking the securities with an intent to distribute. Courts and the Commission also look to the circumstances surrounding the downstream sale. Transaction planners believed this could be used to shorten the necessary holding period. By proving an unforeseen change in circumstances personal to the would-be underwriter, planners felt the holding period should be shortened. Although the Commission consistently refused to issue no-action letters based on this "change of circumstances" defense, planners frequently relied on it in permitting transactions without registration.[81] The availability of this defense and others was uncertain, and the case-by-case analysis led to a subjective morass.

The resultant need for predictability led to SEC promulgation of Rule 144, a safe harbor rule. Rule 144 applies to all sales by control persons, all sales by affiliates of the issuer,[82] and resales of restricted securities (generally restricted to preserve the original exemption) by nonaffiliates.

There are five basic requirements for satisfying the provisions of Rule 144. First, the issuer must make publicly available accurate, current information such as that contained in the reporting requirements of the Securities Exchange Act of 1934.

Second, the seller of the "restricted securities" must have beneficially owned them for a period of at least two years. The two-year holding period begins to run from the latest date the securities were purchased from the issuer or affiliates: Thus, nonaffiliates are permitted to "tack" holding periods. Rule 144(d)(3) provides eight special rules for computing the holding period for certain types of transactions.[83] The full purchase price must be paid for at least two years prior to the sale. The change in circumstances defense[84] is not available for anyone choosing to rely on Rule 144. Since Rule 144 is

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Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) (ten-month holding period held insufficient).

81. *See generally* 1 Louis Loss, Securities Regulation 665–73 (2d ed. 1961); Malcolm Fooshe & Edward McCabe, *Private Placements—Resale of Securities: The Crowell-Collier Case*, 15 Bus. Law. 72 (1959).

82. Rule 144(a)(1) defines *affiliate* as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."

83. Specifically, these rules apply to stock dividends, splits, and recapitalizations; conversions; contingent issuance of securities; pledged securities; gifts of securities; trusts; estates; and Rule 145(a) transactions.

84. *See, e.g.*, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

nonexclusive, the change in circumstances defense arguably survives for those not choosing to rely solely on the safe harbor. However, the SEC has taken the position that the change in circumstances defense has been abolished for all cases.[85]

The third requirement is that all sales of the issuer's securities by the Rule 144 seller and other specified related individuals comply with prescribed volume limitations. Specifically, sales by these persons within the preceding three months may not exceed the greater of the average weekly trading volume during the preceding four weeks or one percent of the issuer's outstanding shares of that class. Nonaffiliates need only comply with this limitation within three years of purchase from the issuer or affiliate. Sales by affiliates must always comply with the volume limitations. Furthermore, all sales of securities of the issuer, restricted or not, are counted together: If the aggregate exceeds the Rule 144(e) limitation, the sales are not exempt.

The fourth requirement for a Rule 144 exemption is that the sales must be section 4(4) unsolicited brokers' transactions, executed in the usual and customary manner, without special commissions or solicitations. Fifth, notice must be transmitted to the SEC of the Rule 144 sales unless the number of shares to be sold is less than 500 *and* their market value is less than $10,000.

Transactions by an Issuer Not Involving a Public Offering—Section 4(2)

Section 4(2) exempts private placements and other "transactions by an issuer not involving any public offering." This exemption was enacted to permit offerings by issuers for isolated sales to particularly sophisticated persons wherein there is no need for the Act's protections. Although the statutory language is somewhat vague, after years of SEC decisions, interpretive releases,[86] and judicial scrutiny, certain key factors have been isolated by the Supreme Court.[87] First, the number of offerees: Although the Supreme Court expressly refused to adopt a "numbers test" as determinative, the number of offerees remains an important factor—the fewer the number, the greater likelihood that a section 4(2) exemption applies. Likewise, the size of the offering is a factor: the smaller the offering, the greater chance for an exemption. Second, access to information: Each offeree should have access to the type of information that would be disclosed should the issuer be required

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85. Securities Act Release No. 33-5223 (Jan. 11, 1972).

86. *See, e.g.*, Securities Act Release No. 33,285 (Jan. 24, 1935); Securities Act Release No. 33-5487 (Jan. 23, 1974).

87. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

to undertake a full-fledged registration. Third, the sophistication of investors: Each offeree should be sophisticated with respect to business and financial matters, as well as with respect to the particular investment being offered.[88] Fourth, the manner of the offering: It should be limited to those who have a privately expressed interest rather than be a general solicitation. Other case law suggests that each offeree must be provided an opportunity to ask questions and verify information through access to the issuer's books and in face-to-face meetings.[89]

Like the section 2(11) "underwriter" definition and the resultant problems with section 4(1) exemptions, the subjective nature of reviewing a vague provision led to much uncertainty and variance among the courts faced with defining the scope of the section 4(2) exemption. As a result, the SEC again responded with a safe harbor rule. The first safe harbor rule adopted was former Rule 146; however, because the rule was extremely complex and technical, few issuers chose to rely on it. The rule was repealed in 1982. In its stead, the Commission adopted Rule 506, which is part of Regulation D and, as discussed below, provides an exemption for certain offers to a limited number of offerees.

The "Section 4(1 1/2)" Exemption

Section 4(2)'s nonpublic offering exemption is limited by its terms to transactions by an issuer. Conceptually, a sale by a person other than an issuer that meets the requirements of section 4(2) should be similarly exempt. However, sometimes it is difficult to point to the statutory provision that would provide the equivalent exemption. For example, where the security has not been held for two years, the Rule 144 exemption is not available. Furthermore, if it is a large block of stock, the section 4(1) exemption may not be available. Thus arose what has become known as the "section 4(1 1/2)" exemption. Although not formally adopted by the Commission, support for this so-called exemption can be found in SEC no-action letters,[90] interpre-

88. *See also* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893 (5th Cir. 1977).

89. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). Several eminent commentators have suggested that as a safety device, each offeree should receive an offering circular containing full disclosure.

90. *See, e.g.*, Sidney Stahl, SEC No-Action Letter (April 23, 1981); Illinois Capital Inv. Corp., SEC No-Action Letter (April 14, 1975); Elwill Dev., Ltd., SEC No-Action Letter (Dec. 5, 1974).

tative releases,[91] judicial decisions,[92] and commentators' writings.[93] Unfortunately, the SEC no-action letters that have been cited as the basis for the section 4(1 1/2) exemption do not provide a consistent statement of what is necessary to satisfy the exemption.[94] Generally, it appears that there are five main considerations in the creation of a section 4(1 1/2) exemption. First, each purchaser must have access to information similar to that which would be made available through a registration statement. Second, each purchaser must meet the section 4(2) qualifications, such as sophistication of the investor or investor's representative. Third, any general solicitation of purchasers destroys the exemption. Fourth, too many section 4(1 1/2) sales within a given time frame could be found to be a distribution, which would destroy the exemption. And fifth, the seller must make clear that the proceeds are going to the selling shareholder, not the issuer.

Although not formally codifying the section 4(1 1/2) exemption, the SEC has promulgated Rule 144A. Rule 144A is a relatively narrow exemption, thus operating more as an experimental adoption of the concept behind the section 4(1 1/2) exemption than as a meaningful safe harbor. It applies only to sales of securities of a class not publicly traded in the United States.[95] This safe harbor permits unlimited resales of securities that have never been registered under the 1933 Act as long as all such sales are made to "qualified institutional buyers."[96] Simultaneously with its adoption of Rule 144A, the

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91. *See, e.g.*, Securities Act Release No. 33-6188 n. 1787, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051 (SEC Feb. 1, 1980); Securities Act Release No. 33-5452, Fed. Sec. L. Rep. (CCH) ¶ 79,633 at 83,698 (SEC Feb. 1, 1974).

92. *See, e.g.*, Ackerberg v. Johnson, 892 F.2d 132 (8th Cir. 1989); Stoppelman v. Owens, [1982–1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,208 (D.D.C. 1984); Neuwirth Inv. Fund, Ltd. v. Swanton, 422 F. Supp. 1187 (S.D.N.Y. 1975); Value Line Income Fund, Inc. v. Marcus, Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965).

93. *See, e.g.*, ABA Committee on Federal Regulation of Securities, *The Section "4(1 1/2)" Phenomenon: Private Resales of Restricted Securities*, 34 Bus. Law. 1961 (1971); Christopher Olander & Margaret Jacks, *The Section 4(1 1/2) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 Sec. Reg. L.J. 339 (1988); Carl Schneider, *Section 4(1 1/2)—Private Resales of Restricted or Control Securities*, 49 Ohio St. L.J. 501 (1988).

94. Christopher Olander & Margaret Jacks, *The Section 4(1 1/2) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 Sec. Reg. L.J. 339, 353 (1988).

95. *E.g.*, small companies, nonconvertible preferred stock, and foreign companies that cannot or will not comply with federal securities laws but seek a U.S. market.

96. Additionally, there are informational requirements unless the issuer is either a reporting company or a foreign issuer. Rule 144A(d)(4)(i).

SEC approved the establishment of the computerized PORTAL[97] system to facilitate trading and provide a more liquid market for Rule 144A securities.

Exemption for Certain Dealer Transactions—Section 4(3)

Section 4(3) provides an exemption from the prospectus delivery requirements for certain transactions by dealers.[98] This exemption is directed generally to the aftermarket, after primary distribution has occurred. Section 4(3)(a) exempts dealer transactions taking place more than forty days after the first date on which the securities were bona fide offered to the public.[99] If a registration statement has been filed, section 4(3)(b) provides that the exemption applies only forty days[100] after (1) the securities were offered to the public or (2) the effective date, whichever is later.[101] Since the vast majority of day-to-day transactions occur more than forty (or ninety) days after the securities have been offered to the public, this exemption covers most transactions. While the exemption is available to underwriters no longer acting as such, section 4(3)(c) makes clear that there is no exemption for transactions in securities that constitute all or part of an unsold allotment or subscription by a dealer who is a participant in the distribution.

SEC Rule 174 provides further exemption under section 4(3) for nonparticipating dealers under certain circumstances by shortening or eliminating the period during which a prospectus need be delivered.[102] Additionally, Rule 174(d) shortens to twenty-five days the "quiet period," where stock is listed on a national securities exchange or qualifies for inclusion on the

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97. Private Offerings, Resales, and Trading through Automated Linkages.

98. In this context, dealer may be understood to include underwriters no longer acting as underwriters.

99. This was intended to cover unregistered offerings and to protect nonparticipating dealers with regard to subsequent transactions, for it permits dealers to trade in a security illegally offered to the public without registration after a lapse of forty days from the time the offering was made. Kubik v. Goldfield, 479 F.2d 472 (3d Cir. 1973).

100. If the registration statement pertains to the issuer's first registered offering, the period is ninety days.

101. Since § 4(3)'s exemption is limited to the prospectus delivery requirements and comes into existence some time after the effective date (or bona fide offering date), it has no bearing on the following: prefiling gun-jumping violations of § 5(c); § 5(a)'s prohibitions against sales prior to the effective date; or § 5(b)(1)'s prospectus delivery requirements during the "waiting period."

102. Under Rule 174, a prospectus need not be delivered to offerees or purchasers (1) if the registration statement is on Form F-6 (for foreign issuers); (2) the company was a public reporting company before the registration statement was filed and is current in its 1934 Act reporting; or (3) in the case of most offerings based on Rule 415 shelf registration.

National Association of Securities Dealers automated quotation system (NASDAQ).

Exemption for Unsolicited Brokers' Transactions—Section 4(4)

Section 4(4) of the Act exempts unsolicited brokers' transactions. There is no explicit definition of broker contained in either the 1933 Act or the rules promulgated thereunder; however, the Act's definition of dealer clearly includes brokers. Thus, unless exempted under section 4(3), and in the absence of section 4(4), brokers' transactions would come within section 5's purview by virtue of the operation of section 4(1). The section 4(4) exemption is limited to unsolicited customer orders and is designed to apply to day-to-day transactions where there is no potential for section 5 abuse. The exemption does not apply, however, to transactions so large that they are susceptible to characterization as a "distribution,"[103] in which case a registration statement would be required unless another exemption is available.

Exemption for Certain Mortgage Notes—Section 4(5)

Section 4(5) is of relatively narrow utility, exempting from registration certain real estate mortgage notes secured by a first lien on a single parcel of real estate consisting of land and either a residential or commercial structure.

Exemption for Offerings Solely to Accredited Investors—Section 4(6)

Section 4(6) exempts offerings made solely to accredited investors where the aggregate amount of securities sold does not exceed the dollar limit of section 3(b) (currently $5 million). *Accredited investor* is defined in section 2(15) of the 1933 Act. The Commission in 1982 exercised its rule-making powers granted in section 2(15) by promulgating Rule 215, which expands the definition of "accredited investors" to include other individuals who are considered sophisticated, who have access to information concerning the issuer, or who are sufficiently affluent to not require the Act's protection in the transaction. Sales under this exemption must be made only to accredited investors, there must not be public advertising or solicitation, and appropriate notice of reliance on the exemption (currently Form D) must be filed with the Commission.

Qualified Exemption for Certain Small Offerings—Regulation A

Under the authority of section 3(b) of the 1933 Act, the SEC promulgated Regulation A[104] to exempt certain "small issues." Regulation A is limited to issuers in the United States or Canada that are not investment companies, and it applies to issues with an aggregate offering price of $1.5 million or

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103. *See, e.g.*, Ira Haupt & Co., 23 S.E.C. 589 (1946).

104. Rules 251–264.

less within a one-year period. The SEC has proposed rules that would raise the limit to the $5 million statutory ceiling for issuer transactions and $1.5 million for secondary transactions. The Regulation A exemption contains "bad boy" disqualification provisions that render it unavailable in most cases if a participant in the offering has been subject to SEC disciplinary proceedings or convicted of a violation of relevant laws in the last five years.[105]

Regulation A is not a complete exemption, but rather is conditioned on what is comparable to a "mini" registration. The issuer must file offering circulars with the SEC. Offers to sell can be made only by way of this offering circular. Copies of all sales materials must be filed with the SEC. Finally, the issuer must file reports of all sales with the SEC regional office (Form 2-a). In general, the advantages of a Regulation A filing are that the information disclosed may be less detailed, it does not require audited financial statements, and it does not subject the issuer to periodic reporting requirements.

Exemption for Certain Small and Limited Offerings—Regulation D

Regulation D consists of three separate private offering and small offering exemptions: Rule 504, an exclusive harbor; Rule 505, an exclusive harbor; and Rule 506, a safe harbor. Rules 504 and 505 are section 3(b) exemptions, while Rule 506 is promulgated under section 4(2)'s nonpublic offering exemption. These three exemptions are all governed by Rules 501, 502, 503, 507, and 508. The exemptions are, of course, exemptions only from registration, not from the antifraud or civil liability sections of the federal securities laws; nor do the exemptions relieve the issuer of the necessity to comply with state securities laws. Regulation D exemptions are available only to the issuer of securities, not to affiliates or purchasers of securities that were initially acquired under Regulation D offerings.

Rule 501 defines the terms used in Regulation D. Particularly important is the definition of accredited investor, found in Rule 501(a).[106] Rule 501(e) provides rules for computation of the number of purchasers.[107]

105. Rule 262. For example, it is unavailable where the issuer, its predecessors, or affiliates are subject to a pending SEC proceeding or have within the preceding five years been subject to an SEC stop order, court securities injunction, or U.S. Post Office fraud order. Similarly, it is unavailable where any of the issuer's directors, officers, principal security holders, current promoters, or underwriters, or any affiliate of such underwriters has been convicted of any crime under the securities laws (not limited to *federal* securities laws) within the preceding five years or has been subject to an SEC or Post Office order. *Id.*

106. 17 C.F.R. § 230.501(a) (1993). There are eight categories that investors may fall within to be an accredited investor. Generally, the categories include institutional

Rule 502 provides general conditions to be met in order to qualify for the exemptions provided by Rules 504, 505, and 506. Rule 502(a) provides an integration safe harbor to prevent other offerings from being integrated into the initial offering and thereby destroying the exemption (e.g., by exceeding the offering price ceiling).[108] Rule 502(b) sets forth informational requirements that must be met for exemptions relying on Rules 505 and 506.[109] In general, the larger the offering, the more information that must be furnished. Rule 502(b) states that the required information must be provided to all unaccredited investors. Formerly, the SEC required that such information be furnished to all investors if there were any unaccredited offerees; this practice is still recommended by the Commission. Rule 502(c) prohibits the offer or sale of securities by general solicitation or general advertising.[110] Finally, Rule 502(d) sets forth limitations on the resale of securities acquired in a Regulation D transaction.[111] Since these exemptions are only "transaction exemptions," any securities acquired pursuant to Regulation D cannot be resold unless the resale is registered or has an independent exemption. The issuer is required by Rule 502(d) to exercise

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investors; individuals with a net worth (or joint net worth) of $1 million; individuals with annual income in excess of $200,000 (or $300,000 joint income with spouse) in each of the two most recent years; and directors, executive officers, and general partners of the issuer. See also 1933 Act § 2(15), Rule 215 for other definitions of accredited investor.

107. This provision is only relevant to Rules 505 and 506 (which are limited to thirty-five purchasers), as Rule 504 has no purchaser limit. Rule 501(e) excludes accredited investors and most related purchasers from the number of purchasers counted.

108. In general, Rule 502(a) provides that offers more than six months before or after the offering at issue may be excluded from integration with Regulation D transactions. However, note that Rules 504 and 505 extend this to twelve months before if the other offering is reliant on an exemption under § 3(b) or illegally offered without registration in violation of § 5(a).

109. Note that no information is required under Rule 504 unless state law requires it.

110. General solicitation includes, but is not limited to, advertising, general meetings, general letters, and circulars. In the limited situation where the exemption being relied on is Rule 504 and all sales are pursuant to (state) registration in states that require delivery of a disclosure document, general solicitation is permitted.

111. Again, in the limited situation where the transaction is relying on Rule 504 for exemption and all sales are pursuant to registration in a state (or states) requiring delivery of a disclosure document, resales need not be restricted.

reasonable care to assure that the purchasers do not unwittingly become underwriters as defined by section 2(11).[112]

Rule 508 provides that insignificant deviations from a term, condition, or requirement of Regulation D will not destroy the exemption for a good faith transaction. This is not designed as a new method of compliance, but rather as a defense in a suit where noncompliance was *de minimus*. To qualify for this excuse, the issuer must show (1) that the failure to comply did not affect the complainant; (2) that it was an insignificant violation with respect to the offering as a whole; and (3) that a reasonable good faith attempt to comply was made.

Rule 503 provides that Regulation D requires filing of notices of sales with the SEC. Moreover, Rule 507, added by the Commission in 1989, provides that Regulation D is not available to persons who have been enjoined from violating Rule 503's notice of sales requirement. This provision may, however, be waived in an individual case by the Commission, upon a showing of good cause.

Offerings up to $1 million—Rule 504. Under Rule 504, which is an exemption promulgated under section 3(b), an issuer that is not an investment company or a 1934 Act reporting company may have an exemption for small offerings. There is a $1 million limit on the aggregate offering price.[113] All securities offered within the past twelve months under a section 3(b) exemption and all securities offered in violation of section 5 within the past twelve months are included in calculating the aggregate offering price.[114] General solicitations of purchasers are permitted and no resale restrictions are required, but only if the offering is registered under applicable state securities (or "blue sky") law provisions.

Offerings up to $5 million—Rule 505. Rule 505, which is also a section 3(b) exemption, exempts certain offerings up to $5 million by issuers

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112. Rule 502(d) contains examples of the requisite "reasonable care," such as placing an appropriate legend on the stock certificate.

113. Currently, only $500,000 of the securities may be attributable to offers and sales of securities not registered under state securities laws. However, the SEC has proposed allowing up to $1 million regardless of state registration.

114. This makes the planning and timing of offerings very important. For example, an issuer cannot have a $500,000 Rule 504 offering following within one year of a $1 million Regulation A offering, since Rule 504 puts a $1 million ceiling on § 3(b) offerings within the preceding twelve months. On the other hand, an issuer can have a $500,000 Rule 504 offering *followed by* a $1 million Regulation A offering, since Rule 254 would permit it as within Regulation A's $1.5 million ceiling on § 3(b) offerings within twelve months.

that are not investment companies.[115] The offering must be limited to thirty-five purchasers, but related purchasers and accredited investors do not count in the limit. No general solicitation is permitted. There are no limitations on the nature of the purchasers; however, there are informational requirements if any of the offerees are not accredited. As with Regulation A offerings, Rule 505 offerings are subject to the "bad boy" disqualification provisions of Rule 262. Resales of the securities relying on this exemption are subject to restrictions.[116]

Safe harbor for nonpublic offerings by issuers—Rule 506. Rule 506, the final exemption in Regulation D, is a safe harbor for a section 4(2) exemption.[117] There is no limit on the dollar amount of an offering under Rule 506. General solicitation of purchasers is not permitted, and the offering is limited to thirty-five unaccredited purchasers.[118] Moreover, all of the unaccredited purchasers must be knowledgeable, sophisticated, and able to evaluate and bear the risks of the prospective investment.[119] Additionally, the purchasers must have access to the information as required by Rule 502(b), and affirmative disclosure of such information must be made by the issuer if there are any unaccredited purchasers. Rule 506, like Rule 505, is subject to the limitations on resale imposed by Rule 502(d), and downstream sales are similarly governed by Rule 144.

Exemption for Certain Compensation and Benefit Plans—Rule 701

Rule 701 is an exclusive (i.e., not merely a safe harbor) exemption under section 3(b) for employee and consultant compensation plans. It is available only to issuers, and the issuer may not be a 1934 Act reporting company or an investment company. This exemption may be used for stock purchase plans, option plans, bonus plans, stock appreciation rights, profit sharing, thrift, incentive, or similar plans. However, the plan must be written, and it may not be used to compensate underwriters or most promoters. The limi-

115. The method of calculation is similar to Rule 504 and Regulation A: include all securities offered within the past twelve months under a § 3(b) exemption (i.e., Regulation A or Rule 504), plus all securities offered in violation of § 5 within the past twelve months.

116. Rule 502(d) requires that resales be made in compliance with Rule 144.

117. As such, it is limited to the scope of the statutory exemption.

118. Related purchasers and accredited investors are excluded from the calculation of the number of purchasers.

119. The former safe harbor rule for § 4(2), Rule 146, used to require this qualification for each offeree. Although this requirement is not specifically stated in Rule 506, disputes over whether a prohibited general solicitation has taken place frequently arise when this qualification is not met. *See, e.g.*, Doran v. Petroleum Mgmt. Corp., 545 F.2d 893 (5th Cir. 1977).

tation on the dollar amount of the compensatory benefit plan varies from $500,000 to $5 million, depending on the size and assets of the company, and the stock outstanding. There are restrictions on resale; thus any downstream sales must be in accordance with Rule 144. Notice of sales relying on this exemption must be filed with the SEC; failure to comply may disqualify the issuer from using the exemption.

Exemption for Certain Offshore Offers and Sales—Regulation S

The SEC has adopted two safe harbor exemptions from registration for qualifying offers and sales outside the United States.[120] Regulation S, which contains the exemptions, is relatively complex and requires not only that the offering process take place outside the United States but also that the securities so offered remain offshore.[121]

Integration of Transactions

The "integration" doctrine is to the SEC what the "step transaction" doctrine is to the IRS. It permits the telescoping of two or more purportedly separate transactions into one transaction. Under the integration doctrine, the SEC and the courts examine multiple offerings to determine whether they should be treated as a single, unitary transaction. When the integration doctrine is employed, it is possible that two or more exempt offerings, when combined, will lose the attributes that entitled them to protection. The integration doctrine is not limited to multiple exempt transactions; it can also be used to integrate a would-be exempt offering with a registered offering where some of the offers or sales in the registered offering would destroy the availability of the exemption.

The integration doctrine first emerged in connection with the intrastate offering exemption in the context of determining which transactions constitute "part of an *issue*" (emphasis added).[122] The SEC has made it clear that integration applies to the transaction exemptions under section 4 and, in particular, the section 4(2) exemption for transactions not involving a public offering. The SEC has developed the following five-factor test[123] to

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120. Rules 901–904.

121. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 14.2 (2d ed. 1990 & Supp.).

122. The "part of an issue" concept applies to § 3(b) exemptions, such as Regulation A. Similarly, the issue concept has been carried over to the § 3(a)(9) exemption for exchanges of securities exclusively with existing securities holders. The integration doctrine has also been applied to the § 3(a)(10) exemption for administratively approved reorganizations.

123. Securities Act Release No. 33-4434 (December 6, 1961).

determine whether the integration doctrine should be applied to two or more transactions:

1. Are the sales part of a single plan of financing?
2. Do the sales involve issuance of the same class of securities?
3. Were the sales made at or about the same time?
4. Is the same type of consideration received?
5. Are the sales made for the same general purpose?

The Commission has not given much guidance on how these factors should be weighted. Accordingly, it would appear that in a particular case any one or more of the five factors could be determinative.[124]

The integration doctrine essentially depends on the facts and nuances of each situation. Therefore, it is often difficult to glean any knowledge from the sparse precedent that exists. Much of the relevant precedent is based on "no action" letters, which by their nature are of limited precedential value.[125] To decrease the uncertainty in some situations, the SEC has developed integration safe harbor rules, such as Rule 502(a) for Regulation D offerings and Rule 147(b)(2) for offerings relying on the intrastate exemption.

Disclosure Requirements in Securities Offerings

Registration Forms

The primary purpose of the Securities Act of 1933 is to promote disclosure of information to potential investors so that they can make informed decisions. The registration statement is the basic disclosure document that issuers must file with the SEC for 1933 Act registration. A number of alternative disclosure forms may be available to issuers for registration, depending on the nature of the issuer, the circumstances surrounding the offering, and the type(s) of securities offered. All registration forms are divided into two principal sections.[126] The information contained in the first portion of the registration statement is the same as that which will be found in the prospectus as required by section 10(a) of the 1933 Act and Schedule A. The Schedule A or statutory prospectus must be delivered before the consummation of any sale pursuant to a registered offering. Schedule A provides only a

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124. Thus, for example, the absence of a prearranged single plan of financing has been held to preclude integration.

125. In 1979 the Commission suspended its practice of rendering "no action" advice on integration questions but reinstituted the practice in 1985.

126. The second part of the registration statement, not discussed in detail here, consists of additional information and exhibits which are not sent out in the prospectus but are available in the SEC files for public inspection.

minimal outline of the types of disclosures required. The specific disclosure requirements are found in the SEC's registration forms and in SEC Regulations S-K, S-B, and S-X. Regulation S-K describes in detail the ways in which the relevant information should be set forth. Regulation S-B provides simplified disclosures for use in certain instances for small business issuers. Regulation S-X addresses accounting matters in significant detail. In analyzing the sufficiency of disclosures in a registered offering (or any disclosure requirements for that matter), it is necessary to consult not only the applicable registration form but also Regulations S-K and S-X.

For nearly fifty years, the SEC administered two parallel disclosure systems: one for registration of public offerings under the 1933 Act and the other for periodic reporting requirements under the 1934 Act. This resulted in duplicative filings and unnecessary paperwork. Therefore, in 1982 the SEC adopted an integrated disclosure system for registration of securities under the 1933 Act. The Commission established a three-tiered system of registration and prospectus disclosure of registrant-oriented information[127] based on the registrant's reporting history and market following. The framework for this system is provided by three registration forms: S-1, S-2, and S-3.

Form S-1 is the basic long-form registration generally available to issuers that do not qualify for one of the other forms. It requires complete information on the registrant and transaction to be provided in the prospectus. As a practical matter, Form S-1 is used primarily for large offerings by first-time issuers and companies with publicly held securities but only a limited number of shareholders.

Form S-2 requires less detailed disclosure. It may be used by any issuer that has been filing reports under the 1934 Act for at least three years. Information that the issuer has reported on Form 10-K of the Exchange Act is incorporated by reference into the prospectus. Along with the description of the offering in the prospectus, the registrant need only provide an annual report or comparable information in the prospectus itself.

Form S-3 requires the least detailed level of disclosure to investors by allowing for the fullest possible incorporation by reference to Exchange Act reporting. No registrant-oriented information is required; only the transaction-specific description of the offering need be disclosed in the prospectus. This form may be used only by issuers that have been reporting companies under the 1934 Act for at least one year. Furthermore, Form S-3 may only

127. The transaction-specific matters (information specific to the securities issuance) should always be disclosed in the registration statement and prospectus.

be used for certain special kinds of offerings, secondary offerings, or if the registrant passes the "market following" test.[128]

In addition to the basic framework for registration established by forms S-1, S-2, and S-3, there are some additional and more specialized forms geared toward certain situations. For example, a simplified Form SB-2 is available for small business issuers.[129] Also, the SEC has adopted Form SB-1 to replace recently rescinded Form S-18, which was a short-form registration statement used for small issues. Form SB-1 may be used for offerings when the aggregate offering price does not exceed $10 million dollars and the securities are to be sold for cash. However, Form S-18 was not available to issuers subject to the 1934 Act reporting requirements; nor was it available to a majority-owned subsidiary of a 1934 Act reporting company.[130] Form SB-1 is available to many more issuers than its predecessor.

In examining completed registration statements, the SEC and the courts have pinpointed a number of areas particularly susceptible to inadequate or misleading disclosures.[131] For example, particular problems in management's

128. Until 1993, the "market following" test contained the alternative standards of a $150 million minimum value of voting stock held by nonaffiliates (the "float"), or a $100 million float and an annual trading volume of at least 3 million shares. *See* Special Report, 1982 Integrated Disclosure Adoptions, Fed. Sec. L. Rep. (CCH) No. 956 at 23–30 (March 11, 1982). In 1993, the "market following" test was reduced to a $75 million float regardless of annual trading volume. The theory behind the "market following" test is that such widely held securities have a sufficiently large informed market following, making more detailed disclosure unnecessary.

129. Other registration forms available for special situations include Form S-4, for mergers and acquisitions; Form S-6, for registration of securities or units in certain investment trusts; Form S-8, for employee stock purchase plans; and Form S-11, for securities issued by certain real estate investment companies.

130. Thus, as a practical matter, it was available only for a first-time public offering.

131. *See, e.g.*, *In re* Universal Camera Corp., 19 S.E.C. 648 (1945). In this case, the SEC identified six common problems in first-time registration made by the defendant: (1) failure to adequately explain the issuer's prior adverse trends in sales and income; (2) failure to divide into *product lines* information about past performance and to explain whether past performance is a reasonable guide to the future; (3) failure to give a detailed description of the use of the proceeds from the offering at issue; (4) failure to disclose and explain transactions involving management and/or affiliated entities (including underwriting discounts, loans to officers, and other potential conflicts of interest); (5) failure to use charts and graphs to explain the disclosures and make the prospectus more readable for potential investors; and (6) insufficient introduction to the registration statement (note that the SEC will also challenge an introduction that is overly verbose).

discussion and analysis have led to requirements[132] seeking more detailed information with respect to the following: the company's plan of operations (in the case of companies going public for the first time); competitive conditions in the company's industry; and dilution resulting from the disparity between the prices paid for the company's securities by public investors and those paid by "insiders."

Adequacy of Registration Statement Disclosures

Under section 8 of the 1933 Act, the SEC may issue a stop order (and thus prevent the issuance of an offering) if it believes the registration statement misstates or omits a "material" fact. Moreover, civil liability may arise when a security is sold under a registration statement that misstates or omits a "material" fact. While the question of what constitutes a "material" fact is discussed more thoroughly in the context of the 1934 Act, it is important to note that for the purposes of a 1933 Act registration statement, Rule 405 defines "material" as "matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." This definition encompasses financial information but is not so limited. For example, "material" has been construed to include the professional[133] *and* personal[134] integrity of management.[135]

There has been controversy over the inclusion in registration statements of "soft" information, such as projections, predictions, and opinion. Originally, the Commission took the position that only "hard" information (i.e., provable, demonstrable facts) should be contained in the registration statement.[136] However, in the late 1970s this position changed, and the SEC even promulgated Rule 175 as a safe harbor rule for "forward-looking statements." Under this rule (and in the courts generally), the issuer is under no duty to provide "soft" information, but if it chooses to do so the information is presumed nonfraudulent and the burden is on the challenger to show either that there was no reasonable basis for the statement or that it was not made in good faith. The Seventh Circuit has held that the issuer

132. *See* Items 101(a)(2), 101(c)(x), and 506 of Regulation S-K.

133. SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978).

134. Franchard Corp., 42 S.E.C. 163 (1964).

135. *But see* Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (holding that materiality does not extend to corporate bad judgment or corruption).

136. For discussions of this position, see, e.g., Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 Bus. Law. 300 (1961); Homer Kripke, *The SEC, the Accountants, Some Myths and Realities*, 45 N.Y.U. L. Rev. 1151 (1970).

may, but need not, disclose the underlying assumptions behind a challenged projection, increasing further the burden on the challenger.[137]

Liabilities Under the 1933 Act

Deficiencies in registration materials can result in administrative action by the SEC, criminal sanctions, injunctive relief, and, in some cases, private remedies.

SEC Administrative Remedies

In order to prevent a deficient registration statement from becoming effective, the SEC can institute formal proceedings for issuing a refusal order. Refusal order proceedings must be instituted within ten days of the registration statement's filing, and the order may be issued only after the registrant has been given notice and an opportunity for a hearing. Alternatively, when faced with material deficiencies in the registration statement, the SEC may commence formal stop order proceedings at any time.[138] Again, the order can be issued only after formal notice and an opportunity for a hearing. However, both of these formal proceedings are rather drastic measures and not a part of the normal process for dealing with deficient registration materials. Instead, the normal process generally involves the use of deficiency letters[139] and other communications between the issuer and the SEC staff, as well as amendments voluntarily delaying the proposed effective date by the issuer until the deficiencies are corrected. In addition to section 8 proceedings, section 8A gives the SEC the authority to issue cease and desist orders.

Private Rights of Action

The 1933 Act has three sections prohibiting fraud and misstatements: sections 11, 12, and 17. Sections 11 and 12 create private rights of action, while section 17(a) is a more generalized antifraud provision used primarily by the SEC and by the Department of Justice in criminal actions.

Any material deficiencies in the registration statement that carry over to the prospectus will result in violations of the section 5(b) prospectus delivery

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137. Wielgos v. Commonwealth Edison, 892 F.2d 509 (7th Cir. 1989). *See also, e.g.*, Roots Partnership v. Land's End, Inc., 965 F.2d 1411 (7th Cir. 1992).

138. *See* William McLucas, *Stop Order Proceedings Under the Securities Act of 1933: A Current Assessment*, 40 Bus. Law. 515 (1985).

139. This is a letter from the SEC staff advising the issuer of changes that the Commission would like to see in the registration statement. For greater detail, see generally 1 Thomas Hazen, Treatise on the Law of Securities Regulation 105–07 (2d ed. 1990); Richard Jennings & Harold Marsh, Securities Regulation 174–75 (5th ed. 1982).

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requirements which call for an accurate and up-to-date prospectus.[140] Any violation of section 5 gives rise to possible criminal sanctions as well as judicially secured SEC equitable sanctions. Furthermore, private remedies may exist for aggrieved persons under sections 11 and 12 of the 1933 Act.

Misrepresentations and Omissions in Registration Statements—Section 11

Section 11 imposes express civil liability on persons preparing and signing materially misleading registration statements. Section 11 is the only liability provision limited to registered offerings. It imposes broader liability than other antifraud provisions because the aggrieved purchaser need only show that he or she bought the security and there was a material misrepresentation in the registration statement. There is no requirement under section 11 that purchasers show that they *relied* on the misstatement. However, there are two standards of liability imposed by section 11. The first is on the issuer, who is, generally, strictly liable once the plaintiff has proved that he or she bought the stock and that there was a material misstatement in the registration statement. The only "affirmative" defenses for the issuer are (1) to show that the person acquiring the security knew of the untruth or omission in the registration statement at the time of the acquisition,[141] (2) lack of materiality, or (3) expiration of the statute of limitations.

The second standard of liability applies to nonissuers. For all persons other than the issuer,[142] section 11(b) provides three additional possible affirmative defenses. The first two defenses relate to someone who discovers the material misstatement or omission and takes appropriate steps to prevent the violation. A potential section 11 defendant may be relieved of liability by either (1) resigning or taking steps toward resignation, and informing the SEC and the issuer in writing that he or she has taken such action and disclaims all responsibility for the relevant sections of the registration statement, or (2) if the registration statement becomes effective without his or her knowledge, upon becoming aware of the effectiveness, he or she takes

140. *See, e.g.*, SEC v. Manor Nursing Ctrs., 458 F.2d 1082 (2d Cir. 1972) (holding that delivery of an uncorrected prospectus, which was not an accurate statement as of the date of delivery, was a violation of § 5(b)(2), subjecting the dealer who delivered the prospectus to liability under § 12(1)).

141. Remember that reliance is not required, so an offer of proof that plaintiff never heard or read the misstatement is irrelevant.

142. Persons liable include all signers of the registration statement (which must include the principal executive and financial officers, the issuer, and a majority of the directors), all directors (including people not yet directors but agreeing to be named as about to become directors), experts (e.g., the certifying accountant), and underwriters. See § 11(a)(1)–(5) for a list of these persons.

appropriate steps toward resignation, informs the Commission as above, and gives reasonable public notice that the registration statement became effective without his or her knowledge.

The third defense, contained in section 11(b)(3), is the most frequently used. This absolves defendants from liability if they had reasonable grounds for believing, and did in fact believe, that there was no omission or material misstatement. Since assertions of actual belief are generally difficult to disprove, the test for this defense centers on what are "reasonable grounds" for believing that no violation occurred. Section 11(c) establishes the appropriate standard of care: "[T]he standard of reasonableness shall be that required of a prudent man in the management of his own property." Thus, this defense is often described as the "due diligence" (although that phrase does not appear in the statute) and reasonable investigation defense.

The courts have not articulated a bright-line test as to what satisfies the due diligence and reasonable investigation standard of care.[143] What has emerged, however, is a sliding scale of culpability depending on the defendant's knowledge, expertise, and status with regard to the issuer, its affiliates, or its underwriters, as well as the degree of the defendant's actual participation in the registration process and in preparing registration materials.[144] In an effort to clarify its position, the SEC promulgated Rule 176, which sets forth factors to be considered, reinforces the judicial sliding scale of culpability, and further provides for the necessity of a case-by-case, highly fact-specific analysis. Rule 176 provides:

> In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer:
>
> (a) the type of issuer;
>
> (b) the type of security;
>
> (c) the type of person;
>
> (d) the office held when the person is an officer;
>
> (e) the presence or absence of another relationship to the issuer when the person is a director or proposed director;

143. *See, e.g.*, Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Feit v. Leaseco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); *In re* Flight Transp. Corp. Sec. Litig., 593 F. Supp. 612 (D. Minn. 1984); Draney v. Wilson, Morton, Assaf & McElligott, 592 F. Supp. 9 (D. Ariz. 1984); *In re* Fortune Sys. Sec. Litig., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,390 (N.D. Cal. 1987).

144. For more detail, see 1 Thomas Hazen, Treatise on the Law of Securities Regulation 290–99 (2d ed. 1990).

(f) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);

(g) when the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter, and the availability of information with respect to the registrant; and

(h) whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

It is appropriate to consider not only the positions held but also any special expertise of the particular person.

Damages under section 11 depend on whether or not the security is sold prior to judgment. The critical dates are the sale date (if the security has been sold prior to suit), the date the lawsuit is filed, and the date of the judgment. If the security is sold before the suit is filed, damages are based on the amount paid less the amount for which the security sold. If the security is sold between the date the suit is filed and the date of judgment, the plaintiff is entitled to the lesser of (1) the amount paid less the price for which the security sold or (2) the amount paid less the value of the security at the time the suit was filed. If the security is held until the date of the judgment, the plaintiff is entitled to the amount paid less the value of the security at the time the suit was filed. Furthermore, defendants are liable only for damages caused by the misleading statement; they have the right to attempt to reduce the damages they must pay by attempting to prove that the decrease in value is the result of something other than their misleading statement. However, section 11 gives the court discretion to award the plaintiff costs and attorneys' fees as part of the damage award.

Liability of Sellers for Violations of Section 5 and Material Misstatements or Omissions in the Prospectus or Otherwise—Section 12

Section 12 of the 1933 Act imposes liability in two contexts: when a person sells a security in violation of section 5, or when a security is sold by means of a prospectus or oral communication that contains a material misstatement or omission. Unlike section 11, section 12 by its terms applies to any transaction, whether or not it is subject to the registration provisions of the 1933 Act.[145] A major issue in many section 12 cases is whether the defendant is a

145. In order for a violation of the federal securities law to occur, some means or instrument of interstate commerce must be used. A number of recent decisions have held that a § 12(2) action cannot be brought in connection with an isolated sale but can apply only in the context of a batch offering. *E.g.*, Ballay v. Legg Mason Wood

permissible one—that is, whether he or she is a "seller" for purposes of section 12. Issuers and underwriters generally are not sellers within the meaning of section 12 unless they actively participate in the negotiations with the plaintiff/purchaser.[146] Similarly, an attorney's having worked on the offering circular will not make him or her a seller.[147] On the other hand, a broker who deals directly with the plaintiff is a section 12 seller.[148]

Section 12 appears to require privity between the plaintiff and the defendant.[149] Traditional agency principles that would give rise to a finding of privity in a normal contract situation apply with equal force in the securities context.[150] The Supreme Court has delineated two factors that should be considered in identifying a seller under section 12: whether the defendant received direct remuneration or benefit as a result of the sale, and whether the defendant's role in the solicitation and purchase was intended to benefit the seller (or owner) of the security.[151]

Civil liability for sales in violation of section 5—section 12(1). Anyone who offers or sells a security in violation of section 5 is liable in a civil action under section 12(1) to the person "purchasing such security from him." In order to recover under this section, the plaintiff need only show

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Walker, Inc., 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991). Although there are increasing numbers of district court decisions supporting this result, it does not seem justified either by the language of the Act or by its legislative history. *See* 1 Thomas Hazen, Treatise on the Law of Securities Regulation at § 7.5 (2d ed. 1990).

146. *See* Foster v. Jesup & Lemont Sec. Co., 759 F.2d 838 (11th Cir. 1985). *See also* Pinter v. Dahl, 486 U.S. 622 (1988) (holding that to be a seller in an action under § 12(1), the defendant must have been both an immediate and direct seller; substantial participation alone will not suffice).

147. *E.g.*, Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988), *cert. denied*, 492 U.S. 918 (1989); Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981).

148. *E.g.*, Quincy Co-Operative Bank v. A.G. Edwards & Sons, Inc., 655 F. Supp. 78 (D. Mass. 1986).

149. The seller "shall be liable to the person purchasing such security *from him* . . . " (emphasis added). *See, e.g.*, Pinter v. Dahl, 486 U.S. 622 (1988); Collins v. Signetics Corp., 443 F. Supp. 552 (E.D. Pa. 1977), *aff'd*, 605 F.2d 110 (3d Cir. 1979); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217 (S.D.N.Y. 1973). While there has been some suggestion that the *Pinter* decision may dispense with the privity requirement, the better view is that it does not. *E.g.*, *In re* Craftmatic Sec. Litig., 703 F. Supp. 1175, 1183 (E.D. Pa.), *modified on other grounds*, 890 F.2d 628 (3d Cir. 1989). *But see* Scotch v. Moseley, Hallgarten, Eastabrook & Weeden, Inc., 709 F. Supp. 95 (M.D. Pa. 1988) (privity not required under Section 12(2) with regard to open-market transaction).

150. *See* Buchholtz v. Renard, 188 F. Supp. 888 (S.D.N.Y. 1960).

151. Pinter v. Dahl, 486 U.S. 622 (1988).

that the defendant sold the security to him or her and that it was unregistered. The defendant then carries the burden of either showing that an exemption existed or establishing the *in pari delicto* (or equal fault) defense. While initially it was believed that the *in pari delicto* defense was unavailable in an action under section 12(1) (since liability imposed under this section is "strict liability"), the Supreme Court has held that the defense is available in private actions under *any* provision of the federal securities laws.[152] Relying on an earlier Court decision,[153] it laid out the two-prong test for the *in pari delicto* defense: First, the plaintiff must be at least equally at fault for the underlying illegality, and second, preclusion of the suit must not offend the "underlying statutory policies."[154] Applying the test to section 12(1) violations (i.e., securities sold in violation of section 5), the Court held that "the *in pari delicto* defense may defeat recovery in a section 12(1) action only where the plaintiff's role in the offering or sale of nonexempt, unregistered securities is more as a promoter than as an investor."[155]

Under section 12(1), the successful plaintiff is entitled to rescission and return of purchase price. If the security has already been sold, damages under section 12(1) are based on the loss comprising the difference between the plaintiff's purchase price and sale price. Since section 12(1) does not require a causal connection between the violation and any decline in price, a successful plaintiff is entitled to rescission even when the price of the security drops due to a change in the issuer's circumstances or market factors wholly unrelated to the section 5 action. Also, it has been held that where there has been a violation of the section 5(b)(1) prospectus delivery requirement followed by the purchaser's receipt of a complete statutory prospectus prior to the delivery of the security, the legal sale does not cure the illegal offer and the purchaser is entitled to maintain an action under section 12(1).[156]

Liability of sellers for material misstatements or omissions—section 12(2). Section 12(2) of the 1933 Act creates an express private remedy for a purchaser against the seller of a security for material misstatements or omissions in connection with the offer and sale. As is the case with section 12(1), section 12(2) is limited to liability of sellers and thus imposes a privity requirement. Once the privity requirement is satisfied, the plaintiff must establish only that there was a material misstatement or omission in the

152. *Id.*

153. Bateman, Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985).

154. Pinter v. Dahl, 486 U.S. 622 (1988).

155. *Id. See also* Mark Klock, *Promoter Liability and* In Pari Delicto *Under Section 12(1)*, 17 Sec. Reg. L.J. 53 (1989).

156. Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971).

prospectus or oral communication. There is no requirement that the plaintiff prove reliance; it will be presumed.[157] The plaintiff also need not have read the misstatement in question.[158]

However, if the plaintiff *knew* of the untruth or omission, the section 12(2) claim should be dismissed.[159] The defendant may also be absolved of liability if "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." It is clear that the section 12(2) "reasonable care" requirement imparts some sort of negligence standard and that it is not necessary for the purchaser to show any type of scienter on the seller's part.[160] Indeed, the section 12(2) standard of reasonable care may impose a duty to investigate in some circumstances.[161] Certain factors can be used to determine whether the defendant did exercise reasonable care: (1) the quantum of decisional and facilitative participation, such as designing the deal and contacting and attempting to persuade potential investors; (2) access to source material against which the truth of the representations could be tested; (3) relative skill in "ferreting out the truth"; (4) pecuniary interest in the transaction's completion; and (5) the existence of a relationship of trust between the investor and the alleged seller.[162]

As with section 12(1), but unlike section 11 or the implied remedy under SEC 1934 Act Rule 10b-5, damages under section 12(2) are limited to either rescission and return of purchase price or, if the purchaser no longer owns the security, damages based on the difference between the purchase price and sale price.

Statute of Limitations in Private Suits Under the 1933 Act

Section 13 of the 1933 Act sets forth the applicable statute of limitations for private remedies under the Act. Actions under sections 11 (material misstatements and omissions in a registration statement) and 12(2) (material misstatements and omissions by sellers of securities) must be brought within one year of discovery of the misstatement or omission, whereas an action under section 12(1) (failure to register or other violation of section 5) must

157. Currie v. Cayman Resources Corp., 835 F.2d 780 (11th Cir. 1988); Austin v. Loftsgaarden, 675 F.2d 168 (8th Cir. 1982); *In re* Conner Bonds Litig., [1988–1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,969 (E.D.N.C. 1988).

158. Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

159. *See* Mayer v. Oil Field Sys. Corp., 803 F.2d 749 (2d Cir. 1986).

160. *See, e.g.*, Wigand v. Flo-Tek, 609 F.2d 1028 (2d Cir. 1979).

161. Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

162. Davis v. Avco Fin. Serv., 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 472 U.S. 1012 (1985).

be brought within one year of discovery of the registration violation. Notwithstanding a longer delay in discovery, actions under sections 11 and 12(2) must be brought within three years after the security was first offered to the public. Section 12(1) actions must be brought within three years of the sale. Section 14 of the Act renders invalid purported waivers of 1933 Act claims, except in connection with settlement of threatened or pending litigation.[163]

SEC Actions and Criminal Prosecutions

Prohibition Against Material Misstatements or Omissions in Connection with the Offer or Sale of Securities—Section 17

In addition to the foregoing private remedies for violation of the prospectus and registration requirements, the 1933 Act imposes sanctions for fraudulent conduct in connection with securities sales. Section 17(a) prohibits fraud, material misstatements, and omissions of fact in connection with the sale of securities. Section 17(a) applies regardless of whether the securities are registered or exempt from registration under section 3. However, unlike its 1934 Act counterpart (Rule 10b-5), section 17(a) applies only to sales of and offers to sell securities. Activities of the offerer or seller are covered, but not fraud by the purchaser. The Supreme Court has addressed the issue of whether scienter is needed to establish a violation under section 17(a)[164] and, in so doing, analyzed section 17(a) according to its subsections. The Court held that scienter must be shown to establish a violation of section 17(a)(1), but not for either section 17(a)(2) (the language of which was found "devoid of any suggestion whatsoever of a scienter requirement") or section 17(a)(3) (which "focuses on the effect of particular conduct on members of the investing public, rather than the culpability of the person responsible").[165] The vast majority of decisions hold that private plaintiffs do not have an implied remedy under section 17(a) of the 1933 Act.

Section 17(b) of the 1933 Act prohibits disseminating information about a security without disclosing any consideration received or to be received, directly or indirectly, in connection with sales of the security. Like section 17(a), section 17(b) applies to securities whether in registration or exempt under section 3. Section 17(b) is designed to prevent the misleading impression of impartiality in certain recommendations. Section 17(b) has been held applicable even to periodicals receiving compensation for favorable recommendations, notwithstanding a challenge that such regulation violates First

163. Meyers v. C & M Petroleum Producers, Inc., 476 F.2d 427 (5th Cir. 1973), *cert denied*, 414 U.S. 829 (1973).

164. Aaron v. SEC, 446 U.S. 680 (1980).

165. *Id.*

Amendment rights of free speech.[166] It was also held that section 17(b) is not limited to securities distributions but applies both to new and outstanding securities.[167]

Violations of section 17 of the 1933 Act may result in both criminal sanctions and an SEC civil suit. A majority of the earlier federal cases recognized an implied right of action under section 17(a).[168] But although a few recent decisions continue to recognize the remedy,[169] the overwhelming majority of recent decisions deny the existence of an implied right of action.[170] In fact, the nonexistence of an implied right under section 17(a) is so clear in some circuits as to justify the imposition of Rule 11 sanctions for claims brought under such a theory.[171]

Secondary Liability Under the 1933 Act

Controlling Person Liability

Section 15 of the 1933 Act imposes joint and several liability on controlling persons for the actions of persons under their control. Controlling person liability will not be imposed if "the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." However, this "lack of knowledge" exception is generally narrowly construed and limited to the basic facts underlying the course of business; lack of knowledge of the par-

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166. SEC v. Wall St. Publishing Inst., Inc., 851 F.2d 365 (D.C. Cir. 1988), *cert. denied*, 489 U.S. 1066 (1989).

167. *Id.*, relying on S. Rep. No. 47, 73d Cong., 1st Sess. 4 (1933) and H.R. Rep. No. 85, 73d Cong., 1st Sess. 6 (1933). This decision makes even more questionable the rule reached in some recent cases that § 12(2) of the Act is limited to "batch offerings." *See* 1 Thomas Hazen, Treatise on the Law of Securities Regulation 290–99 (2d ed. 1990).

168. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.13 (2d ed. 1990).

169. *See, e.g.*, Letizia v. Prudential Bache Sec., Inc., 802 F.2d 1185 (9th Cir. 1986); Gaff v. FDIC, 814 F.2d 311 (6th Cir. 1987) (but denying standing to an offeree who did not purchase).

170. *See, e.g.*, Schlifke v. Seafirst Corp., 866 F.2d 935 (7th Cir. 1989); Newcome v. Esrey, 862 F.2d 1099 (4th Cir. 1988); Krause v. Perryman, 827 F.2d 346 (8th Cir. 1987); Landry v. All Am. Assurance Co., 688 F.2d 381 (5th Cir. 1982). Additional cases are collected in 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.13 (2d ed. 1990).

171. Crookham v. Crookham, 914 F.2d 1027 (8th Cir. 1990) ($10,000 sanction for bringing suit under § 17(a) of the 1933 Act).

ticular transaction does not preclude controlling person liability.[172] Some courts have held that the broader common-law rules of ***respondeat superior*** do not apply in light of the statutory provisions dealing with controlling person liability. However, the clear majority of the federal courts of appeals hold that statutorily imposed controlling person liability does not preclude application of either the common law principle of ***respondeat superior*** or the agency concepts of actual or apparent authority.[173]

Aiding and Abetting Liability

Aside from the provisions on controlling person liability, neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 expressly imposes liability on secondary participants in securities violations. The courts have nevertheless applied common-law principles of aiding and abetting to reach many such offenders. Although there is scattered authority to the contrary, the vast majority of cases hold that aiding and abetting principles do not apply to broaden the range of defendants in private actions under sections 11 and 12 of the 1933 Act. The Supreme Court has expressly reserved, but appears about to answer, the question of whether a person can be held accountable for aiding and abetting;[174] however, every court of appeals that has faced the issue has recognized aiding and abetting as a proper basis for

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172. San Francisco–Okla. Petroleum Exploration Corp. v. Carstan Oil Co., 765 F.2d 962 (10th Cir. 1985). Likewise, controlling person liability does not require the controlling person's participation in the wrongful conduct. *See, e.g.*, G.A. Thompson & Co. v. Partridge, 636 F.2d 945 (5th Cir. 1981); Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985); Steinberg v. Illinois Co., 659 F. Supp 58 (N.D. Ill. 1987). ***But see*** Durham v. Kelly, 810 F.2d 1500 (9th Cir. 1987) (corporate president's wife exercised some control but was not held liable, since she did not induce the misstatements in question); Buhler v. Audio Leasing Corp., 807 F.2d 833 (9th Cir. 1987) (broker-dealer not liable for failure to supervise off-book sales).

173. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991); Henricksen v. Henricksen, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 449 U.S. 1011 (1981); Commerford v. Olson, 794 F.2d 1319 (8th Cir. 1986) (decided under 1934 Act § 20, the equivalent controlling person liability provision under the Exchange Act); *In re* Atlantic Fin. Mgmt., Inc. Sec. Litig., 784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987) (also decided under 1934 Act § 20). A different rule applies, however, to actions complaining of insider trading. *See* 1934 Act § 21A(b)(1).

174. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191–92 n.7 (1976). *See* Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 113 S. Ct. 2927 (1993) (granting certiorari).

liability under the generalized antifraud provisions, including SEC actions and criminal prosecutions under section 17(a).[175]

There is broad agreement among the circuits on the elements necessary to establish aider and abettor liability. First, the court must find a primary violation of the securities laws.[176] Second, the aider and abettor must be found to have a "general awareness" that his or her role was part of an overall plan of wrongdoing.[177] Finally, the aider and abettor must have given knowing and substantial assistance to the person perpetrating the primary violation.[178]

The courts are split on whether a person can be held liable as an aider and abettor when his or her sole assistance was through silence and inaction. Some courts have held that aider and abettor liability can arise when the person remained silent with the conscious intent of furthering the fraud.[179] Other courts have found aider and abettor liability for silence and inaction only where the person had an independent duty to disclose the securities violation.[180] Alternatively, the Fifth Circuit has found aider and abettor liability when the aider and abettor either acted with the specific intention of

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175. *See, e.g.*, Cleary v. Perfectune, 700 F.2d 774 (1st Cir. 1983); Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983); Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

176. SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *But see* Kaliski v. Hunt Int'l Resources Corp., 609 F. Supp. 649 (N.D. Ill. 1985) (although "lulling" activities can constitute a primary violation of the securities laws, they are not sufficient to establish aiding and abetting liability).

177. *See, e.g.*, SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *See also* Buffo v. Graddick, 742 F.2d 592 (11th Cir. 1984); *In re* Gas Reclamation, Inc. Sec. Litig., 659 F. Supp. 493 (S.D.N.Y. 1987); Antinore v. Alexander & Alexander Serv., Inc., 597 F. Supp. 1353 (D. Minn. 1984).

178. *See, e.g.*, SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *See also* Kilmartin v. H.C. Wainwright & Co., 580 F. Supp. 604 (D. Mass. 1984); SEC v. Rogers, 790 F.2d 1450 (9th Cir. 1986); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp. 271 (S.D.N.Y. 1987).

179. *See, e.g.*, IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Rochez Bros. v. Rhoades, 527 F.2d 880 (3d Cir. 1975); SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Martin v. Pepsi-Cola Bottling Co., 639 F. Supp. 931 (D. Md. 1986).

180. *See, e.g.*, Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974); Quintel Corp., N.V. v. Citibank, N.A., 589 F. Supp. 1235 (S.D.N.Y. 1984); Dahl v. Gardner, 583 F. Supp. 1262 (D. Utah 1984); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

furthering the fraud or had an independent duty to disclose the facts underlying the violation.[181]

181. *See, e.g.*, Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975).

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The Regulation of Issuers, Securities Professionals, and the Securities Markets Under the Securities Exchange Act of 1934

Structure and Scope of the 1934 Act

The Securities Exchange Act of 1934 presents a broad umbrella of regulation. In addition to market and financial regulation, the 1934 Exchange Act imposes disclosure and other obligations on issuers of securities. The three principal targets of the 1934 Act are issuers, markets, and market professionals. Oversight of the securities markets and market professionals is accomplished not only directly by the SEC but also by systems of self-regulation which are overseen by the Commission.

Issuers of securities are regulated by both the 1933 Act and the 1934 Act. The 1933 Act regulates distribution of securities; the 1934 Act deals with day-to-day trading.[182] The 1934 Act has an issuer registration requirement apart from the 1933 Act. Registration of securities under the 1934 Act triggers periodic reporting requirements. There are some instances in which issuers who do not have to register securities under the 1934 Act will nevertheless be subject to that Act's periodic reporting provisions. While most of the 1934 Act's regulation applies only to registered and/or reporting companies, two important provisions are not so limited: (1) the general antifraud provisions of section 10(b) and, in particular, SEC Rule 10b-5; and (2) the tender offer antifraud provision found in section 14(e).

There are two jurisdictional bases for regulation of securities and their issuers under the 1934 Act. First, some of the regulation is triggered by use of an instrumentality of interstate commerce.[183] The second basis for jurisdiction is found in the registration provisions of section 12 and the periodic reporting provisions of sections 13 and 15.

Section 12 of the 1934 Act requires registration of most publicly traded securities.[184] Under section 12(a), any security that is traded on a national

182. The 1934 Act requires registration and reporting of most publicly traded securities; it also regulates proxy solicitation, tender offers, other control-related transactions, and insider transactions.

183. *See, e.g.*, Rule 10b-5 and § 14(e).

184. Section 15(d) applies periodic reporting requirements to still others.

exchange must be registered under the 1934 Act.[185] Section 12(a) thus covers exchange-traded equity securities (stock and securities convertible into stock), exchange-traded options (puts and calls),[186] and exchange-traded debt securities (bonds). The registration provisions of section 12 further apply to equity securities that are publicly traded in over-the-counter markets through the facilities of the National Association of Securities Dealers (NASD),[187] rather than on an exchange. Section 12(g)(1) requires registration of certain equity securities that are not listed on a national securities exchange. Section 12(g)(1) applies on its face to companies with more than $1 million in assets which have a class of equity securities held by 500 or more persons. However, the SEC has narrowed the number of companies subject to 1934 Act registration. Rule 12g-1 exempts issuers if the company has less than $5 million in gross assets.[188] The registration and consequent periodic reporting obligations cease if on the last day of each of the issuer's last three fiscal years, the issuer (1) has had fewer than 300 shareholders of record of that class of securities or (2) has had assets not exceeding $5 million.[189] In such cases, the issuer may withdraw its registration.

185. The 1934 Act's registration requirement is set forth in § 12(g). It is quite different from 1933 Act registration; a corporation that has registered a class of securities under the 1934 Act will still have to register each particular offering of that class of securities under the 1933 Act.

186. Options are included in the definition of equity securities, since they are convertible into equity securities.

187. The NASD operates the "over-the-counter" market, distinguished originally from the exchanges in two principal ways: (1) there is no central facility comparable to an exchange floor (although the NASD's introduction in 1971 of an electronic automated quotation system, NASDAQ, and more recently its "national market system" have made this distinction less important); and (2) the function of a firm representing an individual buyer is different (in an exchange, the firm acts as a "broker" and the only "dealer" is the registered "specialist" in that stock; in the over-the-counter market, any number of firms may act as "dealers" or "market makers" in a particular stock).

188. There is an exemption from 1934 Act registration for securities of foreign issuers, over-the-counter American Depositary Shares, and American Depositary Receipts representing such securities. 1934 Act § 12(g)(3) and Rule 12g3-2. The exemption depends on annually furnishing the SEC with all information that must be disclosed according to the laws of the issuer's domicile. This exemption was modified in 1983 and is no longer available for NASDAQ-listed securities; however, securities qualifying prior to that time retain their exempt status.

189. Rule 12h-3. To give an example of the numbers, there are approximately 3,000 exchange-listed securities (stocks and bonds, not options) and approximately 6,000 securities traded in the over-the-counter markets.

Registration under the 1934 Act brings with it periodic disclosure obligations. Section 13 of the 1934 Act sets forth the periodic reporting requirements. The basic reports that must be filed with the SEC are (1) Form 10-K, an annual report; (2) Form 10-Q, a quarterly report; and (3) Form 8-K, interim "current reports." Form 8K's interim reporting requirements are quite limited,[190] and, as a general rule, companies are not under an affirmative duty to disclose information until the next quarterly report.

Prohibition of Manipulative Activities

Section 9(a) prohibits "wash sales," "matched sales," or any other transactions entered into simultaneously where the purpose is to create a "misleading appearance of active trading." This section also prohibits any exchange-based transactions that give the artificial impression of active trading, as well as transactions entered into for the purpose of depressing or raising the price of the securities. Furthermore, section 9(a)(6) empowers the Commission to promulgate rules prohibiting "pegging, fixing, or stabilizing" securities prices.[191]

Another type of manipulation covered by section 9 involves exchange-traded options, or put and call options.[192] Section 9(b) gives the SEC rule-

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190. The types of items that must be disclosed on Form 8K are as follows: (1) changes in control of the registrant (within fifteen calendar days of the change); (2) acquisition or disposition of a significant amount of assets, not in the ordinary course of business, by the issuer or any of its majority-owned subsidiaries (within fifteen calendar days of the event); (3) bankruptcy or receivership (within fifteen calendar days of the event); (4) change of certifying accountant (within five days of the event); (5) any other events not called for by this form but which the registrant deems important; (6) resignation of directors (within five days of the event); and (7) change in fiscal year (within fifteen calendar days of the decision).

191. The problem of stabilization has been addressed by the SEC in Rules 10b-6, 10b-7, and 10b-8.

192. Note that the provisions relating to options do not apply to warrants (options issued by the issuer). Furthermore, they are limited to options with regard to securities and are not to be confused with future contracts or options relating to commodities, which are regulated by the Commodities Futures Trading Commission. A call option is a contract between a seller (the option writer) and a buyer, under which the option buyer has the right to exercise the option and thereby purchase the underlying security at an agreed-upon price (the "strike" or "exercise" price). The option will expire unexercised (and hence valueless) unless it is exercised within a specified time period, the last day of which is the expiration date. A put option, conversely, gives the option's buyer the right to exercise the option by selling the underlying security. The put option seller must purchase the underlying security at the agreed-upon price if the option is exercised on or before the expiration date. If

making power over options transactions where there is no intent to follow through with the rights and obligations of the option with respect to the underlying security. The Commission has not imposed any substantive prohibitions, but rather has elected to deal with put and call options for securities by requiring an adequate disclosure document to purchasers and sellers.

Shareholder Voting: Federal Regulation of Proxies and Proxy Solicitation

In addition to periodic reporting requirements, 1934 Act registrants are subject to the federal proxy rules established under section 14 of the Act. Although state corporate law governs shareholder voting rights generally, federal securities law regulates the proxy machinery of publicly held companies. There are four primary aspects of SEC proxy regulation. First, by virtue of section 14(a), there must be full and fair disclosure of all material facts with regard to any management-submitted proposals that will be subject to a shareholder vote. Second, material misstatements, omissions, and fraud in connection with the solicitation of proxies are prohibited, and the courts have recognized implied private remedies for injured investors.[193] Third, the federal proxy regulation facilitates shareholder solicitation of proxies, since by virtue of Rule 14a-8, management is required not only to submit relevant shareholders' proposals in its own proxy statements but also to allow the proponents to explain their position in the face of any management opposition. Fourth, the proxy rules mandate full disclosure in non-management proxy materials and thus are significant in control struggles and contested takeover attempts.

Under section 14 of the 1934 Act, whenever there is a proxy solicitation with regard to shareholder votes (or consent to action) for holders of securities subject to section 12's registration requirements, the solicitation must be in line with SEC disclosure requirements. Section 14(a) is limited to proxy solicitation materials and procedures. Accordingly, that section does not apply if shareholder votes or consents by proxy are not solicited. When there is

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the strike price is "out of the money" in comparison with the price of the underlying security, so that it would not make ecomonic sense to exercise the option, the option will simply expire unexercised. As will be discussed more fully later, option contracts can be used either for speculation or to hedge existing securities positions. *See generally*, Thomas Hazen, Treatise on the Law of Securities Regulation § 1.5.1 (2d ed. 1990); Thomas Hazen, *Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets*, 86 Nw. U. L. Rev. 987, 989–90 (1992).

193. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

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no proxy solicitation made by the issuer's management, section 14(c) nevertheless requires management to mail a statement containing information similar to that required for a proxy solicitation to the shareholders in advance of any shareholders' meeting.[194]

The proxy rules govern disclosure but not voting mechanics.[195] In Rules 14a-3 through 14a-12, the Commission sets forth the types of information that must be disclosed in proxy solicitations subject to the Act. The Commission distinguishes between the proxy[196] and solicitation[197] materials. All solicitations must be accompanied or preceded by a written proxy statement containing the information required by Schedule 14A.[198] Required disclosures include information about the person making the solicitation and details relating to the transactions in question. If the solicitation is made on the issuer's behalf, the proxy statement must be accompanied or preceded by an annual report to security holders.[199] The annual report must contain financial information as well as management's analysis of operations.

The federal proxy rules also provide for shareholder access to information.[200] The shareholder proposal rule, Rule 14a-8, tells management which

194. 15 U.S.C. § 78n(c) (1988). These informational requirements are set out in Regulation 14C, 17 C.F.R. §§ 240.14c-1 to 14c-7 (1993), and Schedule 14C, 17 C.F.R. § 240.14c-101 (1993).

195. The mechanics of shareholder voting and what are proper matters for shareholder consideration are determined by state law.

196. Defined in Rule 14a-1(f) to include any shareholder consent or authorization regarding the casting of that shareholder's vote. Requirements for the appropriate form of the proxy itself can be found in Rule 14a-4.

197. Defined in Rule 14a-1(*l*) to include the following: any request for a proxy; any request to execute or not to execute, or to revoke, a proxy; or any communication to shareholders reasonably calculated to result in the procurement, withholding, or revocation of a proxy. Rule 14a-2 lists the types of solicitations exempt from the proxy rules. Rule 14a-3 sets forth the types of information that must be included in proxy solicitations.

198. Rule 14a-3. Five preliminary copies of the proxy statement, form of proxy, and any soliciting material must be filed with the SEC at least 10 calendar days prior to the date definitive copies are sent or distributed to security holders. Rule 14a-6.

199. Rule 14a-3(b). See also Regulation 14C, which requires dissemination of the annual report in years when the registrant does not engage in a proxy solicitation.

200. See Rule 14a-7, designed for nonmanagement persons intending to make a solicitation. Upon request, management must either supply a list of security holders or offer to mail the solicitation materials at a reasonable cost to the requesting party. The Seventh Circuit has held that violations of Rule 14a-7 mailing requirements can give rise to private rights of action. Haas v. Wieboldt Stores, Inc., 725 F.2d 71 (7th Cir. 1984).

shareholder proposals must be included in management's proxy statement. The basic thrust of Rule 14a-8 is that a shareholder proposal which is proper for consideration under state law must be included in the management's proxy statement along with a brief statement explaining the shareholder's reason for supporting the proposal's adoption, provided that it is submitted to the issuer in a timely fashion. For his or her proposal to be included, a proponent must have owned for at least one year the lesser of 1% or $1,000 in market value of such securities, and must continue to be a security holder through the date on which the shareholders' meeting is held. The proposal submission must be timely under the requirements of Rule 14a-8(a)(3). Furthermore, a shareholder may submit only one proposal per year that qualifies for mandatory inclusion in management's proxy statement. In addition to the proposal itself, the proponent may provide a supporting statement, but there are length limitations. Certain proposals, even if filed properly and in a timely fashion, may be excluded by the issuer. However, if a proposal is valid under state law and is properly excludable, it must nevertheless be described in the issuer's proxy statement.[201]

Rule 14a-9 embodies the general antifraud proscriptions applicable to proxy solicitations. The Supreme Court has repeatedly recognized an implied remedy for private parties seeking to address violations of Rule 14a-9's antifraud provisions.[202] However, many issues other than the existence of a private remedy are still litigated in the context of these Rule 14a-9 actions. These issues include standing, materiality, causation, the proper standard of liability, and damages.

Presumably, in order to establish standing to sue, all a private plaintiff needs to show in a Rule 14a-9 action is that he or she was injured in connection with a proxy solicitation covered by the Exchange Act's regulation.[203] In fact, it has been held that a shareholder has standing to challenge a misleading proxy statement by alleging direct injury notwithstanding the ab-

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201. Schedule 14A, item 21.

202. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

203. *See, e.g.*, District 65, UAW v. Harper & Row Publishers, 576 F. Supp. 1468 (S.D.N.Y. 1983) (plaintiff must be a shareholder at the time of the proxy solicitation); Palumbo v. Deposit Bank, 758 F.2d 113 (3d Cir. 1985) (director has standing to bring suit under the proxy rules); Ameribanc Investors Group v. Zwart, 706 F. Supp. 1248 (E.D. Va. 1989) (even the issuer or target corporation has standing to sue under the proxy rules).

sence of his or her alleging actual reliance.[204] All that is necessary is that the reliance of some shareholders on the statement was likely to have affected the outcome of their votes.

One of the basic elements of a claim based on one of the securities law antifraud provisions is that the misstatements or omissions were "material" to the transaction. The Supreme Court found the determination of "materiality" to be a mixed question of law and fact, and declared that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[205] This definition appears to have stood the test of time, having been adopted again by the Court in determining materiality in the context of a Rule 10b-5 action,[206] and was echoed in an SEC rule pertaining to materiality in the context of 1934 Act registration and reporting.[207] This same materiality test is also applied to 1933 Act disclosure obligations (as well as to disclosures required under the other securities laws that are not discussed herein).

It is difficult to generalize with regard to issues of materiality, since the decisions are highly fact-specific. However, the cases do in large part reflect the common law of misrepresentation, which states that opinions, predictions, intentions, and mere statements of value are generally not actionable.[208] Nondisclosure or inadequate disclosure of conflicts of interest frequently constitute material misrepresentations.[209] However, in some contexts, nondisclosure of the directors' motivation for supporting or oppos-

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204. *See, e.g.*, Bradshaw v. Jenkins, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,645 (W.D. Wash. 1984). *But cf.* Atkins v. Tony Lama Co., 624 F. Supp. 250 (S.D. Ind. 1985) (claim dismissed because allegations negated any possibility of reliance, a necessary element of a fraud claim).

205. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

206. Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

207. Rule 12b-2.

208. *See, e.g.*, Mendell v. Greenberg, 612 F. Supp. 1543 (S.D.N.Y. 1985), *aff'd in part and rev'd in part*, 927 F.2d 667 (2d Cir. 1991) (mere opinion is not actionable); Nutis v. Penn Merchandising Corp., 610 F. Supp. 1573 (E.D. Pa. 1985), *aff'd*, 791 F.2d 919 (3d Cir. 1986) (failure to disclose that terms of proposed merger were "grossly unfair" held not actionable); Hahn v. Breed, 587 F. Supp. 1369 (S.D.N.Y. 1984) (expressions of opinions of future prospects held not actionable).

209. *See, e.g.*, Wilson v. Great Am. Indus., Inc., 855 F.2d 987 (2d Cir. 1988).

ing a particular transaction has been held not material so long as there was full disclosure of all relevant facts surrounding the transaction.[210]

In addition to materiality, establishing an actionable violation of the proxy rules requires the private plaintiff to establish causation. Causation under the proxy rules' private right of action has been a somewhat elusive concept. A showing of cause in fact is the first step in establishing a sufficient causal nexus between the defendant's conduct and the plaintiff's injury.[211] Once cause in fact has been established, it must be shown that the causal connection is sufficiently proximate in order to warrant recovery. In securities law, as with common-law fraud, there must be a direct causal connection between the act and the injury; collateral breaches of fiduciary duties will not be sufficient to state a claim.[212] The Supreme Court stated that the proper test of causation in a Rule 14a-9 action is whether upon full and fair disclosure, a reasonable shareholder's voting decision would likely have been affected.[213]

Another issue in proxy rule litigation is the degree of culpability required to establish a defendant's violation. Two circuit courts of appeals have upheld private Rule 14a-9 claims based on negligence.[214] Although a few courts have indicated that scienter is required in actions under Rule 14a-9,[215] the Supreme Court's ruling in *Aaron v. SEC*,[216] though decided

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210. *See, e.g.*, Kademian v. Ladish Co., 792 F.2d 614 (7th Cir. 1986); Morrissey v. County Tower Corp., 717 F.2d 1227 (8th Cir. 1983); Vaughn v. Teledyne, Inc., 628 F.2d 1214 (9th Cir. 1980); Warner Communications v. Murdoch, 581 F. Supp. 1482 (D. Del. 1984).

211. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) (decided under Rule 10b-5).

212. *See, e.g.*, Ketchum v. Green, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) (insufficient connection); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (sufficient connection); *In re* Tenneco Sec. Litig., 449 F. Supp. 528 (S.D. Tex. 1978) (insufficient connection); Superintendent of Ins. v. Freedman, 443 F. Supp. 628 (S.D.N.Y. 1977), *aff'd*, 594 F.2d 852 (2d Cir. 1978) (insufficient connection).

213. Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). *See also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

214. Herskowitz v. Nutri/System, Inc., 857 F.2d 179 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989); Wilson v. Great Am. Indus., Inc., 855 F.2d 987 (2d Cir. 1988). *Accord* Gillette Co. v. RB Partners, 693 F. Supp. 1266 (D. Mass. 1988); Fradkin v. Ernst, 571 F. Supp. 829 (N.D. Ohio 1983).

215. *See, e.g.*, Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980), *cert. denied*, 449 U.S. 1067 (1980).

216. 446 U.S. 680 (1980).

under section 17(a) of the 1933 Act, seems to mandate that a showing of negligent conduct would suffice.

Material misstatements and omissions in connection with a proxy solicitation can result in civil liability to shareholders who can show injury. In an appropriate case, a court may enjoin a shareholder meeting or any action voted on at that meeting when there have been significant violations of the proxy disclosure and filing requirements.[217] Injunctive relief may also be secured in an SEC enforcement action,[218] and in an appropriate case, the SEC can refer the matter for criminal prosecution.[219] However, it is difficult to unscramble eggs; because of the practical difficulties involved and hardships placed upon innocent third parties, only rarely will a court set aside a transaction that has already been consummated. In many cases, the inability of an aggrieved shareholder to secure injunctive relief makes the damage action the plaintiff's only meaningful remedy. Calculation of damages in the proxy context is a much more amorphous process,[220] since proxy rule violations do not always result in a sale of securities or some other readily identifiable reference point for computing damages. This, coupled with the paucity of cases on point,[221] means that there is little guidance for assessing the prospects of a claim for damages in a proxy area not based on a transaction in shares or corporate assets (where dollar amounts may be more readily identifiable).

In addition to the foregoing antifraud rules, federal proxy regulation has separate provisions for director elections. Rule 14a-11 regulates the solicitation of proxies with regard to the election or removal of directors at annual or special meetings of securities holders. The rule requires identification of all participants in the solicitation process as well as an attribution of the source(s) of all materials used in the solicitation. All sources of financing behind the solicitation must also be disclosed.

217. *See, e.g.*, Condec Corp. v. Farley, 573 F. Supp. 1382 (S.D.N.Y. 1983) (no showing of irreparable injury; preliminary injunction denied); Citizens First Bancorp, Inc. v. Harreld, 559 F. Supp. 867 (W.D. Ky. 1982) (although plaintiff stated a claim, preliminary injunction was denied because of plaintiff's failure to show that otherwise there would be irreparable injury).

218. *See, e.g.*, SEC v. May, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956) (preliminary injunction granted in an action against shareholders waging a proxy battle).

219. *See, e.g.*, United States v. Matthews, 787 F.2d 38 (2d Cir. 1986).

220. *See, e.g.*, Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

221. The absence of much guidance from the courts is due to the fact that in most cases the plaintiff either has been unsuccessful or has settled prior to a judgment on the merits.

One of the more significant director election disclosure items is the requirement of Schedule 14A and Schedule 14B (which applies to solicitations made by persons other than the issuer) for disclosure of the nominee's experience in office. Nondisclosure of a director's conduct in office may be a material omission with respect to a shareholder's decision on how to cast his or her vote.[222] As is the case with disclosures generally, the pertinent information relating to the composition of the board of directors[223] and the directors' conduct must be disclosed clearly and conspicuously.

Regulation of Tender Offers and Takeover Bids—The Williams Act Amendments to the Exchange Act

During the 1960s the securities markets witnessed a substantial increase in the use of tender offers (publicly announced offers to purchase the shares of a target company) in lieu of the more conventional statutory merger route as a means of effecting corporate combinations. The increased use of tender offers was due in part to the fact that target companies subject to the Exchange Act's reporting requirements were required to hold a shareholder vote and to comply with the Act's proxy rules when participating in a statutory merger. The competitive atmosphere and vociferousness with which such takeover battles were waged became extreme in terms of both public and private ramifications. This climate led to the 1968 Williams Act amendments to the 1934 Act, enacted to regulate these tender offers and takeover bids. The Williams Act is codified in sections 13(d), 13(e), 14(d), 14(e), and 14(f) of the 1934 Exchange Act.

Section 13(d) of the Exchange Act performs an important early warning function: It puts investors and the target company's management on notice of a possible impending takeover attempt. Section 13(d) requires the filing of a disclosure statement on Schedule 13D by any person (or group), other than the issuer, who directly or indirectly acquires beneficial ownership of 5% or more of a class of equity securities registered pursuant to section 12.[224] Once a person has reached this 5% threshold, he or she has ten days

222. Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979).

223. SEC v. Falstaff Brewing Corp., 629 F.2d 62 (D.C. Cir.), *cert. denied*, 449 U.S. 1012 (1980) (proxy solicitation defective where the fact that proxies sought by management for approval of a stock sale would in effect transfer control of a corporation to a third party was buried in pages of minute print).

224. That disclosure must include (1) the background and identity of the person(s); (2) the source and amount of funds used to make the purchases; (3) the purpose of the purchases; (4) the number of shares beneficially owned; and (5) any contracts, arrangements, or understandings involving securities of the issuer. However, some institutional investors may qualify for the short-form Schedule 13G. An issuer's

in which to file the Schedule 13D.[225] After the Schedule 13D filing, there is a ten-day moratorium on additional purchases.

As defined by section 13(d)(3), a "person" includes a "partnership, limited partnership, syndicate, or other group." Accordingly, a Schedule 13D must be filed when members of a "group" aggregately acquire 5% of a class of equity securities subject to the 1934 Act's reporting requirements. The Second Circuit has held that the determinative factor is whether a group holding securities has been established pursuant to an express or implied agreement, thus presenting the *potential* for a shift in control; no agreement to purchase further securities is necessary.[226] In contrast, the Seventh Circuit requires more explicit evidence of a concerted effort to form a "group." Under the Seventh Circuit's approach, the group must have an agreement not only to exert control but also to acquire additional shares for the purpose of exerting control.[227]

A group may be deemed to exist when individual parties agree to act in concert to purchase additional shares, regardless of the absence of a common plan with respect to the target corporation beyond the additional share ac-

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purchases of its own shares, directly or through an affiliate, are subject to similar disclosure requirements under § 13(e).

225. While initially intended to prevent accidental violations of the securities laws, the ten-day "window" frequently is used for additional undisclosed acquisitions of the target company's stock; there have been attempts to close this window. *See, e.g.*, 15 Sec. Reg. & L. Rep. (BNA) 1156 (June 17, 1983) (a panel commissioned by the SEC recommended that the 13(d) filing be due in advance of the purchases); 16 Sec. Reg. & L. Rep. (BNA) 793 (May 11, 1984) (legislative proposals by the SEC to close the ten-day window); D'Amato Introduces Comprehensive Proposal for Tender Offer Reform, 19 Sec. Reg. & L. Rep. (BNA) 84 (Jan. 24, 1987).

226. GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972). *Accord* Staley Continental, Inc. v. Drexel Burnham Lambert, Inc., [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,698 (D.D.C. 1988); Financial Gen. Bankshares v. Lance, [1978–1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,403 (D.D.C. 1978). *See also* K-N Energy, Inc. v. Gulf Interstate Co., 607 F. Supp. 756 (D. Colo. 1983). *Cf.* SEC v. First City Fin. Corp., 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989) (beneficial ownership based on relationship and understandings in the absence of a formal agreement). *But see* Advanced Computer Techniques Corp. v. Lecht, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,795 (S.D.N.Y. 1982).

The same court has held that the member's agreement to acquire control is established by purchase of the 5% threshold. Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207 (2d Cir. 1973). However, discussions by various persons of the possibility of entering into an agreement alone do not establish the formation of a group. Lane Bryant, Inc. v. Hatleigh Corp., 517 F. Supp. 1196 (S.D.N.Y. 1981).

227. Bath Indus. v. Blot, 427 F.2d 97 (7th Cir. 1970).

quisitions.[228] Formation of a group via an agreement among existing shareholders owning in the aggregate more than 5% of a class of equity securities will trigger the section 13(d) filing requirement even though no additional shares are to be purchased. Whether a failure in the Schedule 13D to disclose the existence of a group constitutes a material misstatement or omission depends on the facts of the case.[229]

Rule 13d-3 sets forth the Commission's standards for determining who is a beneficial owner for purposes of section 13(d) and section 13(g)[230] filing requirements. Section 13(d)(4) addresses the computation of the 5% threshold.

Section 13(d)(6) exempts certain acquisitions from the filing requirements of sections 13(d) and 13(g). The terms of section 13(d)(6) give the SEC the power to provide additional exemptions through rule making.[231]

Section 13(d)'s filing requirements are aimed at creeping acquisitions and open-market or privately negotiated large block purchases. In contrast, section 14(d)'s filing requirements, section 14(e)'s general antifraud proscriptions, and section 14(f)'s disclosure requirements relating to new directors are all triggered by a "tender offer." "Tender offer" is not defined in the Williams Act. Both the courts and the SEC have construed the term broadly, providing a flexible definition. The SEC has suggested an eight-factor test to determine whether a tender offer exists. The eight factors can be summarized as follows:

1. whether there is active and widespread solicitation of public shareholders;
2. whether there is solicitation for a substantial percentage of the issuer's stock;

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228. Mid-Continent Bancshares, Inc. v. O'Brien, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,734 (E.D. Mo. 1981).

229. *Compare* SEC v. Savoy Indus., Inc., 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979) *with* Treadway Co. v. Care Corp., 638 F.2d 357 (2d Cir. 1980).

230. *See, e.g.*, Stichting Phillips Pensionbonds A and B, SEC No-Action Letter, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,668 (Jan. 12, 1988) (foreign pension fund investing in regular course of its business and not with a view toward affecting control of target company qualified for Schedule 13G).

231. Rule 13d-6 exempts purchases whereby the purchaser becomes more than a 5% beneficial owner if the acquisition is made pursuant to preemptive subscription rights, provided that (1) an offering is made to all holders of securities of the same class; (2) the person acquiring securities does not acquire any additional securities other than through the pro rata share offering of preemptive rights; and (3) the acquisition is duly reported, if required, pursuant to § 16(a).

3. whether the offer to purchase is made at a premium over prevailing market price;
4. whether the terms of the offer are firm rather than negotiable;
5. whether the offer is contingent on the tender of a fixed minimum number of shares;
6. whether the offer is open only for a limited period of time;
7. whether the offerees are subject to pressure to sell their stock; and
8. whether public announcements of a purchasing program precede or accompany a rapid accumulation of stock.[232]

These factors are simply broad guidelines. Hence, any predictability must be gleaned from the cases and SEC rulings.[233] Cases involving both open-market and privately negotiated stock purchases seem to turn on whether or not the "pressure-creating characteristics of a tender offer"[234] accompany the transactions.[235] Although the cases conflict, a number of decisions have held that most privately negotiated transactions are susceptible to categorization as tender offers; however, most privately negotiated purchases are

232. The eight-factor test, which is not contained in an official SEC release, has evolved over a period of time and is discussed in Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979); Hoover Co. v. Fuqua Indus., Inc., [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,107 (N.D. Ohio 1979).

233. *See, e.g.*, Holstein v. UAL Corp., 662 F. Supp. 153 (N.D. Ill. 1987) (poison pill plan which involved distribution of rights held not a tender offer); Beaumont v. American Can Co., 621 F. Supp. 484 (S.D.N.Y. 1984), *aff'd*, 797 F.2d 79 (2d Cir. 1986) (cash option portion of a merger with a cash election feature is not a tender offer); *In re* Pain Webber, Jackson & Curtis, Inc., 15 Sec. Reg. L. Rep. (BNA) 131 (SEC Dec. 12, 1982) (block trade of 9.9% is a tender offer); Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) (five privately negotiated purchases and one open-market purchase were not a tender offer; the transactions in question have been referred to as an "end run" because they were preceded by a tender offer that was withdrawn and then followed by a second tender offer); SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985) (issuer's open-market purchase program in response to third-party tender offer was not a tender offer subject to § 13(e)); Dyer v. Eastern Trust Co., 336 F. Supp. 890 (N.D. Me. 1971) (a large block purchase of shares made without the intent to obtain control held not to be a tender offer).

234. Ludlow Corp. v. Tyco Labs., Inc., 529 F. Supp. 62, 68 (D. Mass. 1981).

235. *See also* Zuckerman v. Franz, 573 F. Supp. 351 (S.D. Fla. 1983) (highly publicized cash merger proposal at a premium above the market price constituted a tender offer); S-G Sec., Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114 (D. Mass. 1978) (publicly announced intention to acquire a substantial block of stock followed by rapid acquisition of 28% of shares of target company held a tender offer).

not tender offers unless they subject the seller to undue pressure.[236] The theme that emerges from the cases is that when a privately negotiated attempt to take control of a company raises problems that the Williams Act is designed to cover, a tender offer may exist.

Once an offer is deemed a tender offer, it is governed by various procedural provisions of the Williams Act. In general, section 13(e) and the rules promulgated thereunder regulate issuer tender offers, or "self tender offers," and sections 14(d), (e), and (f) and the rules promulgated thereunder regulate tender offers by third parties. The rules governing third-party tender offers and issuer tender offers are basically the same. There are six important requirements placed on tender offers by the Williams Act: (1) disclosure requirements; (2) rules regulating shareholder withdrawal rights; (3) the "pro rata" rule; (4) the "all holders" rule; (5) the "best price" rule; and (6) rules governing the duration of the tender offer. Most of these apply only to offers for securities registered under the 1934 Act (sections 13(e) and 14(d) and applicable rules), but some of the federal tender offer regulations applies regardless of 1934 Act registration (section 14(e) and applicable rules).

Section 14(d)(1) of the Exchange Act requires that all "tender offer material" for equity securities subject to the registration requirements of section 12 must be filed with the SEC and accompanied by the appropriate disclosures. Section 14(d) requires disclosures of the type specified by Schedule 13D, in addition to other information the SEC may require. As with Schedule 13D, the section 14(d) filings must be updated to reflect material changes and developments.[237] Section 14(d) does not apply to an is-

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236. *See, e.g.*, Cattlemen's Inv. Co. v. Fears, 343 F. Supp. 1248 (W.D. Okla. 1972) (any privately negotiated purchase that interferes with a shareholder's "unhurried investment decision" and "fair treatment" of investors defeats the protections of the Williams Act and is probably a tender offer); *In re* G.L. Corp., [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,494 (April 15, 1980) (offer for all or none purchase at a premium may be a tender offer); Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979) (secret offers to twenty-eight of target company's largest shareholders, giving each of them only from half an hour to overnight to decide, constituted a tender offer). *Cf.* Kennecott Copper Corp. v. Curtis-Wright Corp., 584 F.2d 1195 (2d Cir. 1978) (acquisition of nearly 10% of target company's shares does not constitute a tender offer where tender offeror and solicited shareholder agree on secrecy and the private nature of the transaction, and no high-pressure tactics are used); Energy Ventures, Inc. v. Appalachian Co., 587 F. Supp. 734 (D. Del. 1984) (series of privately negotiated transactions not involving high pressure did not constitute a tender offer).

237. *See, e.g.*, *In re* Revlon, Inc., Exchange Act Release No. 34-23320 (June 16, 1986) (finding violations of Rule 14d-4 for failure to amend the Schedule 14D-9 to reflect defensive merger negotiations).

suer's acquisition of its own shares—those transactions are covered by section 13(e), which, by virtue of SEC rule making, imposes regulations for issuer tender offers that are comparable[238] to Regulation 14D's rules for third-party offers.

Under the Williams Act, shareholders have the right at certain times to withdraw their tendered shares from a tender offer. Section 14(d)(5) provides that all securities deposited pursuant to a tender offer may be withdrawn during the first seven days of the tender offer and at any time after sixty days from the date of the original tender offer. This has been extended by the SEC rules to permit tendered securities to be withdrawn at any time while the tender offer remains open. The rules also set out the proper form for notice of withdrawal.

The "pro rata" rule requires pro rata acceptance of shares tendered where the tender offer by its terms does not obligate the tender offeror to accept all shares tendered.[239] This takes pressure off the target company's shareholders who would otherwise have to make a quick decision should acceptance be on a first-come basis.

The "all holders" rule prohibits discriminatory tender offers that exclude one or more shareholders from participating.[240] There is an exception to the "all holders" requirement when the tender offer is in compliance with a constitutionally valid state statute.[241] Furthermore, in addition to reserving general exemptive power under the "all holders" rule,[242] the SEC has promulgated a specific but limited exemption for "odd-lot tender offers" by issuers.[243]

The "best price" rule states that the highest price paid to any tendering security holder must be paid to all tendering security holders.[244] This re-

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238. *See, e.g.*, Rule 13e-1.

239. Section 14(d)(6) extended for the entire period of the tender offer by Rule 14d-8 for third-party tender offers and Rule 13e-4(f)(3) for issuer tender offers.

240. Rule 14d-10(a)(1) for third-party tender offers; Rule 13e-4(f)(8)(i) for issuer tender offers. These rules were promulgated after (and perhaps in response to) a Delaware decision that upheld a tender offer by an issuer that excluded a hostile tender offeror. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (D. Del. 1985).

241. Rule 14d-10(b)(2) for third-party tender offers; Rule 13e-4(f)(9)(ii) for issuer tender offers.

242. Rule 14d-10(e); Rule 13e-4(g)(7).

243. Rule 13e-4(g)(5). An odd-lot offer is one limited to security holders owning less than a specified number of shares under 100. Within that group, however, both the "all holders" and "best price" requirements will apply to the terms of the odd-lot offer.

244. Rule 14d-10(a)(2) for third-party tender offers; Rule 13e-4(f)(8)(ii) for issuer tender offers.

quirement applies only to shares purchased during a single tender offer. As such, unlike state "fair price" statutes,[245] it does not regulate two-tiered offers consummated in two distinct steps. However, it can be important if a series of transactions are integrated and held to be parts of a single tender offer.[246] The SEC best price rule does not prohibit differentiation in types of consideration, and the different consideration need not be substantially equivalent in value so long as the tender offer permits each tendering security holder to select among the types of consideration offered.[247] As is the case with the all holders rule, the SEC has the power to grant exemptions from the best price requirement.[248]

The Williams Act also prescribes minimums for the duration of tender offers. At a bare minimum, a tender offer must remain open for at least twenty business days. This requirement applies even for tender offers for securities of target companies not registered under the 1934 Act.[249] Any increase or decrease in the consideration offered under the tender offer triggers the requirement that the tender offer be open for ten business days from the date of change in consideration.[250] Furthermore, notice of any "material" change in the terms of the offer must be made in a manner reasonably designed to inform shareholders of that change.[251]

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245. *See, e.g.*, Md. Code Ann., Corps. & Ass'ns §§ 3-602, 3-603 (1993).

246. *See, e.g.*, Field v. Trump, 850 F.2d 938 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989) (upholding complaint that withdrawal of first tender offer was a sham). *But cf.* Brill v. Burlington N., Inc., 590 F. Supp. 893 (D. Del. 1984) (December tender offer that was terminated and January tender offer addressed to same class of shareholders were two separate tender offers). See also § 14(d)(7) of the Exchange Act, which provides that whenever a person varies the terms of a tender offer or request before the expiration thereof by increasing the consideration offered, the person making such an increase must pay to all persons tendering that same price whether or not the securities were tendered prior to the variation of the tender offer's terms.

247. Rule 14d-10(c) for third-party tender offers; Rule 13e-4(f)(10) for issuer tender offers.

248. Rule 14d-10(e); Rule 13e-4(g)(7).

249. Rule 14e-1(a) for third-party tender offers; Rule 13e-4(f)(1)(i) for issuer tender offers.

250. Rule 14e-1(b) for third-party tender offers; Rule 13e-4(f)(1)(ii) for issuer tender offers.

251. Rule 14d-4(c) for third-party tender offers; Rule 13e-4(e)(2) for issuer tender offers. The SEC has interpreted this to mean that a material change would require holding the offer open for at least five days from the date of notice and for ten days where the change is as significant as a change in consideration or the percentage of securities sought.

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When a tender offer is made for equity securities subject to the Exchange Act's reporting requirements, section 14(f) requires full disclosure of any agreements concerning the designation of new directors, unless the designation is made through a formal vote at a meeting of the securities holders. Contemplated management turnover, including any arrangement regarding the makeup of the majority of directors, also must be disclosed.[252] The purpose of section 14(f)'s disclosure requirements is to assure that shareholders and other investors are aware of any changes in management control that are to take place without a shareholder vote. The required disclosures keep security holders posted as to all material information, including new directors' backgrounds and relationships with the issuer both in terms of employment contracts and stockholdings.

In a potentially far-reaching decision, the Supreme Court in *Schreiber v. Burlington Northern, Inc.*,[253] limited the thrust of section 14(e). *Schreiber* involved a claim that the defendant target company's renegotiation of the terms of a tender offer was manipulative and therefore in violation of section 14(e). Rather than directly confront the issue of what constitutes "manipulative conduct," the Court held that "without misrepresentation or nondisclosure, section 14(e) has not been violated."[254] In a rather unusual review of the section's legislative history, the Court concluded that disclosure was the sole thrust of the section,[255] in effect excising "manipulative conduct" from the terms of the statute. The ramifications of this decision, if overextended and literally applied, not only could eviscerate Regulation 14E as discussed below but also could carry over to section 10(b), on which section 14(e) was based. This could lead to the unwise and unfortunate result of invalidating a number of the section 10(b) rules dealing with manipulative conduct. The courts, however, have been reluctant to give *Schreiber* such an unwarranted broad reading.[256]

Although it is clear that the SEC may investigate suspected violations and bring enforcement actions, it is not entirely clear whether the Williams Act authorizes implied rights of action. In general, the courts seem to favor the existence of at least a limited implied remedy (for material misstatements or omissions) under section 14(e)'s antifraud provision. The availability of an

252. Rule 14d-4(c) for third-party tender offers; Rule 13e-4(e)(2) for issuer tender offers. *See also* Rule 14f-1.

253. 472 U.S. 1 (1985).

254. *Id.* at 12.

255. "Nowhere in the legislative history is there the slightest suggestion that Section 14(e) serves any purpose other than disclosure . . . ." *Id.* at 11.

256. Polaroid v. Disney, 862 F.2d 987 (3d Cir. 1988) (upholding the validity of the all holders rule, which prohibits excluding shareholders from a tender offer).

implied remedy under the Williams Act's filing requirements, sections 13(d), 13(e), and 14(d), is also significant.[257] The cases are in conflict, but a number of decisions have held that the relevant provisions of sections 13 and 14 themselves provide a basis for at least limited private relief. Courts seem more likely to grant injunctive relief[258] than damages.[259] The Supreme Court has indicated *in dicta* that a target company may have standing to complain of delays by a purchaser in filing a Schedule 13D where it can show a resultant injury.[260]

Liabilities Under Section 14(e)

Section 14(e) of the Exchange Act prohibits material misstatements, omissions, and fraudulent practices in connection with tender offers regardless of whether the target company is subject to the Exchange Act's reporting requirements.[261] It is not necessary to disclose very preliminary merger discussions; however, the Supreme Court has held that whether preliminary merger negotiations have crossed the materiality threshold is a question of

257. Since these sections all apply to issuers subject to the 1934 Exchange Act's registration and reporting requirements, and involve mandatory filings with the SEC, other remedies for material misstatements may be available. For example, an investor who is injured by actual reliance on material misstatements in the mandatory filings may sue for damages under the express remedy provided in § 18(a) of the Act. Furthermore, any material misstatements or omissions that give rise to an injury in connection with the purchase or sale of a security will form the basis of a cause of action under Rule 10b-5. However, no private remedy appears to exist under Rule 10b-5 for mere delay in making the required filing. Thus it is important to determine if an implied remedy exists under the Williams Act's filing requirements.

258. *See, e.g.*, Conagra, Inc. v. Tyson Foods, Inc., 708 F. Supp. 257 (D. Neb. 1989) (preliminary injunction granted); Morrison Knudsen Corp. v. Heil, 705 F. Supp. 497 (D. Idaho 1988) (exercise of control enjoined until deficiencies cured in § 13(d) filings); Schnell v. Schnall, 550 F. Supp. 650 (S.D.N.Y. 1982); Berman v. Metzger, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,857 (D.D.C. 1981).

259. For a recent case holding that § 14(d)(7) can support a damage action, see Field v. Trump, 850 F.2d 938 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989). *See also, e.g.*, Sanders v. Thrall Car Mfg. Co., 730 F.2d 910 (2d Cir. 1984), *aff'g*. 582 F. Supp. 945 (S.D.N.Y. 1983); Dan River, Inc. v. Unitex Ltd., 624 F.2d 1216 (4th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981); Chromalloy Am. Corp. v. Sun Chem. Corp., 611 F.2d 240 (8th Cir. 1979); Liberty Nat'l Ins. Holding Co. v. Charter Co., 734 F.2d 545 (11th Cir. 1984). *But see* American Bakeries Co. v. Pro-Met Trading Co., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,925 (N.D. Ill. 1981); Gateway Indus., Inc. v. Agency Rent A Car, Inc., 495 F. Supp. 92 (N.D. Ill. 1980).

260. Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975).

261. In contrast, the other provisions of the Williams Act are limited to securities of issuers subject to § 12's registration requirements.

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fact[262] depending on whether a reasonable investor would consider them significant in making an investment decision.[263]

The Supreme Court has also determined that there is no private remedy for a competing tender offeror.[264] In so holding, the Court did not rule out any private remedy; in fact, the opinion held out much hope for the recognition of a section 14(e) private right of action in the hands of the target company or its shareholders. The Court in *Piper* reasoned that the purpose of the Williams Act was to further investor protection by serving the shareholders of the target company, not competing tender offerors, who, at best, were collateral beneficiaries of the tender offer provisions. Most lower courts have recognized a remedy in the hands of the target company or one of its shareholders,[265] as well as the right of a competing tender offeror to seek injunctive relief.[266]

A target company and its shareholders have standing to sue under section 14(e). The Supreme Court has indicated that a private right of action, if it exists at all, works in favor of the target company shareholders and, in an appropriate case, in favor of the target company.[267] Again, most circuit and district court opinions dealing with the question have recognized a private right of action under section 14(e) by a target company or its shareholders. Target company shareholders, but not the target company management, may be able to assert claims under Regulation 14D.[268]

Liabilities Under the 1934 Act

Manipulation of Exchange-Traded Securities—Section 9(e)

Section 9 of the 1934 Exchange Act outlaws manipulative practices in connection with the trading of exchange-listed securities. It also provides a private remedy for investors injured by the prohibited manipulative conduct. Section 9 does not apply to securities traded in the over-the-counter mar-

262. Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

263. *Id.*; *see* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

264. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977).

265. *See, e.g.*, Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355 (2d Cir. 1979) (recognizing the § 14(e) remedy but finding no substantive violation). *See also* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); H.K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973).

266. *See, e.g.*, Humana, Inc. v. American Medicorp, Inc., 445 F. Supp. 613 (S.D.N.Y. 1977).

267. In Piper v. Chris-Craft, Inc., 430 U.S. 462 (1977), the Supreme Court held that a competing tender offeror does not have standing to sue under the Williams Act's general antifraud provision for tender offers (§ 14(e)).

268. Polaroid v. Disney, 862 F.2d 987 (3d Cir. 1988).

kets. Manipulation of nonexchange securities is prohibited by sections 10(b) and 15(c), which do not contain an express private right of action. Manipulation is interpreted narrowly, not extending to many acts that effectively alter the price of a security. Presumably, "manipulation" has the same meaning under each of the Exchange Act provisions. The Supreme Court has repeatedly stated that manipulation is a "term of art" limited to certain types of transactions specifically designed to artificially affect the price of a security.[269]

Section 9(e) provides a private remedy in damages to any investor injured by conduct violating section 9 (limited to securities listed on a national exchange). In addition to costs and reasonable attorneys' fees, the successful plaintiff is entitled to damages based on the difference between the actual value and the price as affected by the manipulative conduct. Liability under section 9(e) is expressly limited to persons "willfully" participating in the manipulative conduct. The plaintiff must also prove manipulative intent.[270]

The section 9(e) remedy has been described as follows:

> To show a violation of section 9(a)(2) in a private suit under section 9(e), a plaintiff must plead and prove that (1) a series of transactions in a security creating actual or apparent trading in that security or raising or depressing the price of that security (2) carried out with scienter (3) for the purpose of inducing the security's sale or purchase by others (4) was relied on by the plaintiff and (5) affected the plaintiff's purchase or selling price.[271]

Although the foregoing test indicates that plaintiffs must prove actual reliance and reliance on market price alone will not suffice, this limitation may be questionable in the face of the "fraud on the market" theory of reliance.[272] Nevertheless, it is patently clear that even without this element,

269. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976); Schreiber v. Burlington N., Inc., 471 U.S. 1 (1985).

270. *See* Annotation, *What Constitutes Willfulness or Manipulative Purpose So As to Warrant Imposition of Liability in Private Civil Action Based on Price Manipulation Provisions of Securities Exchange Act (15 USCS §§ 78i(a)(2), 78i(e))*, 25 A.L.R. Fed. 623 (1975).

271. Ray v. Legman Bros. Kuhn Loeb, Inc., 624 F. Supp. 16, 19 (N.D. Ga. 1984), *quoting* Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149, 1164 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983), *reh'g granted*, 718 F.2d 725 (5th Cir.), *cert. denied*, 460 U.S. 1013 (1983).

272. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (upholding the fraud on the market presumption of reliance in Rule 10b-5 actions). Fraud on the market is discussed in the text accompanying notes 300-301, *infra*.

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the section 9(e) remedy is a rather limited one. Market manipulation and deceptive practices are also regulated by sections 10, 14(e), and 15(c).

Section 16 of the 1934 Act, discussed more fully in a later section, is intended to prevent corporate "insiders" from engaging in "short-swing" trading.[273] Section 16(a) requires every officer, director, and beneficial owner of more than 10% of any class of equity security registered under section 12 of the Act to file disclosure notices with the SEC. These notices must disclose all ownership interest in any of the issuer's equity securities. The notice must be filed within ten days of a person's becoming an officer, director, or beneficial owner of more than 10% of a class of securities, as well as within ten days of the end of every calendar month in which there has been a change in that person's holdings. These reports are then made available to the public at the SEC's office in Washington, D.C. The Commission also publishes monthly summaries of the reports.

Section 18 of the 1934 Act provides an express right of action for any investor injured by purchasing or selling securities in reliance on a materially misleading statement or omission in a document required to be filed with the SEC. However, the usefulness of section 18 has been largely diminished by the courts' "eyeball" test: that is, the plaintiff must have actual knowledge of and must have relied on the materials filed with the Commission (or a copy thereof); it is not sufficient that the plaintiff saw similar information in other documents prepared by the issuer.[274]

Fraud and Implied Rights of Action

Through the 1970s, the federal courts were generally willing to recognize implied private rights of action under the securities laws. Since the mid-1970s, the Supreme Court has shown less willingness to recognize implied rights of action. Nevertheless, the existing implied antifraud remedies under Rules 10b-5 and 14a-9 are firmly established.

Kardon v. National Gypsum,[275] a 1946 Eastern District of Pennsylvania decision involving a closely held corporation, was the first case to recognize a private remedy under SEC Rule 10b-5. Starting in the 1970s, the Supreme Court repeatedly recognized an implied private right of action under Rule

273. *I.e.*, using their access to nonpublic information about important, impending corporate actions to trade short-term in the securities of the company for profit.

274. *See, e.g.*, Ross v. A.H. Robins Co., 607 F.2d 545, 552 (2d Cir. 1979); Jacobson v. Peat, Marwick, Mitchell & Co., 445 F. Supp. 518, 525 (S.D.N.Y. 1977).

275. 69 F. Supp. 512 (E.D. Pa. 1946). In 1949, the first decision recognized an implied remedy under § 17(a) of the 1933 Act, but most recent decisions have held *contra*.

10b-5. In *J.I. Case v. Borak*,[276] the Court recognized a private right of action under the proxy rules utilizing a "tort" theory of liability.[277]

In 1975, the Court set forth a restrictive test for determining when implied remedies should be recognized. In *Cort v. Ash*,[278] the Court identified four factors:

1. Is the plaintiff one of the class for whose especial benefit the statute is enacted?
2. Is there any evidence of legislative intent to create such a remedy or to deny one?
3. Is the recognition of an implied remedy consistent with the underlying purposes of the legislative scheme?
4. Is the area of law one that is traditionally relegated to the states?

Subsequent decisions have made it clear that additional implied remedies are at best doubtful.[279] In addition, a few courts have begun to award Rule 11 sanctions against claims based on other provisions where the implied remedy has been denied.[280]

The Implied Remedy Under SEC Rule 10b-5

The primary private remedy for fraud available under the Securities Exchange Act has been implied from SEC Rule 10b-5. The rule was promulgated under section 10(b), which gave the SEC power to make rules prohibiting the use of "manipulative or deceptive device[s] or contrivance[s]

276. 377 U.S. 476 (1970).

277. The proxy rules are found in § 14(a) and Rule 14a-9.

278. 422 U.S. 66 (1975).

279. Subsequent Supreme Court decisions have put more weight on legislative intent than on the other three factors. In 1982, the Supreme Court recognized an implied right of action under the Commodity Exchange Act, reasoning, inter alia, that the lower federal courts have recognized such an action for years while Congress sat by in silence. Curran v. Merrill Lynch Pierce Fenner & Smith, 456 U.S. 353 (1982). Following *Curran* there may be only faint hope for plaintiffs seeking recognition of additional remedies under the federal securities laws. The two exceptions are § 14(e) and § 29(b) of the 1934 Act, which provide that any contract in violation of the Act or any rule promulgated thereunder is void.

280. Crookham v. Crookham, 914 F.2d 1027 (8th Cir. 1990) ($10,000 sanction for bringing suit under § 17(a) of the 1933 Act). In addition to § 17(a) of the 1933 Act, other sections that are unlikely to support an implied remedy include § 7 of the 1934 Act (margin violations) as well as violation of rules of self-regulatory organizations. *See* 1 Thomas Hazen, Treatise on the Law of Securities Regulation §§ 10.11, 10.14 (2d ed. 1990).

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. . . in connection with the purchase or sale of securities."[281] The rule declares:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

No express provisions in the securities laws prescribe civil liability for a violation of Rule 10b-5. However, as far back as 1946, the courts followed the normal tort rule that persons who violate a legislative enactment are liable in damages if they invade an interest of another person whom the legislation was intended to protect.[282]

Of the three separate clauses in Rule 10b-5, the third is generally assumed to have the broadest scope. There are five principal elements of this type of Rule 10b-5 claim: the plaintiff must show (1) fraud or deceit (2) upon any person (3) in connection with (4) the purchase or sale (5) of any security.

One of the requirements of fraud is scienter. In 1976, the Supreme Court held that a valid claim for damages under Rule 10b-5 must establish that the defendant acted with scienter.[283] In 1980, the Court held that the scienter standard applies under Rule 10b-5 regardless of whether the action is a private damage action or an enforcement action brought by the Commission.[284] In these cases, the Court did not decide whether a showing of reckless conduct would satisfy the scienter requirement.[285] However, the majority of lower court decisions have found that recklessness is sufficient to state a claim under Rule 10b-5.[286]

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281. Other rules authorized under this section include Rules 10b-6, 10b-7, and 10b-8, addressing market manipulation; Rules 10b-4 and 10b-13, addressing conduct during a tender offer; and Rule 10b-16, addressing requisite disclosure in margin transactions.

282. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

283. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

284. Aaron v. SEC, 226 U.S. 680 (1980).

285. *Hochfelder*, 425 U.S. at 193–94 n.12; *Aaron*, 446 U.S. at 690–91.

286. *See, e.g.*, Van Dyke v. Coburn Enter., 873 F.2d 1094 (8th Cir. 1989); Rankow v. First Chicago Corp., 870 F.2d 356 (7th Cir. 1989); Stephenson v. Paine Webber, Jackson & Curtis, Inc., 839 F.2d 1095 (5th Cir.), *cert. denied*, 488 U.S. 926

An important corollary to the "purchase or sale" requirement is that in order to have standing to sue, a Rule 10b-5 plaintiff in a private damages action must have been either a purchaser or seller of the securities that form the basis of the material omission, misstatement, or deceptive conduct.[287] In *Blue Chip Stamps*, the plaintiff had a right to purchase the securities in issue under an antitrust consent decree, but refrained on the basis of allegedly misleading statements made by the defendants. The Court held that this would-be purchaser could not state a Rule 10b-5 cause of action. It seems apparent that, likewise, mere "would-be" sellers cannot raise Rule 10b-5 claims.[288] Most courts also allow a remedy for a corporation (or a shareholder derivative suit) for certain transactions, including corporate repurchases of its own shares at an inflated price or an additional issuance of corporate shares on an unfavorable basis.[289]

The courts have generally assumed that it is not necessary for the defendant to have been a purchaser or seller of securities in order to have violated Rule 10b-5.[290] Any statement reasonably calculated to affect the investment decision of a reasonable investor will satisfy the "in connection with" requirement.[291]

(1988) (reckless/due diligence standard applied to plaintiff); Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982).

287. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

288. In fact, this was the prevailing view even before *Blue Chip Stamps*. *See, e.g.*, Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974); Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968); Jensen v. Voyles, 393 F.2d 131 (10th Cir. 1968).

289. *See, e.g.*, Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980) (repurchase of shares); Bailes v. Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971) (issuance of shares); Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964) (issuance of shares); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (issuance of shares). *But cf.* Smith v. Ayers, 845 F.2d 1360 (5th Cir. 1988) (shareholder suing in individual capacity and complaining of corporation's issuance of shares lacked Rule 10b-5 standing).

290. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (upholding liability for misleading statement but not directly addressing whether defendant's not being a purchaser or seller precluded liability); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (imposing a purchaser/seller standing requirement on the plaintiff).

291. SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (misstatements in a corporate press release were made "in connection with" purchases and sales made by shareholders in the open market and violated Rule 10b-5, even though the corporation itself was not buying or selling shares); Pelletier v. Stuart-James Co., 863 F.2d 1550 (11th Cir. 1989) (fraudulent scheme need not relate to "investment value" of security); Ellis v. Merrill Lynch & Co., 664

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"Purchase or sale" has likewise been construed broadly. Share exchanges or cashouts pursuant to a corporate merger or other business combination will ordinarily constitute purchases and sales for Rule 10b-5 purposes.[292] However, a share exchange or merger with a shell company undertaken merely for "corporate restructuring" has been held not to constitute a purchase or sale under Rule 10b-5.[293] Furthermore, as mentioned above, a corporation's repurchase of its own shares or an additional issuance of its shares may give rise to a shareholder derivative claim.[294] A purchase or sale pursuant to a tender offer can form the basis of a Rule 10b-5 claim. A pledge of securities is generally held to be a sale subject to a Rule 10b-5 claim,[295] although there is some disagreement on this point.[296] A secured creditor who is injured because of a foreclosure sale of securities has been held to have standing to sue under Rule 10b-5.[297]

Rule 10b-5 applies to any purchase or sale by any person of *any* security. The fact that a security is exempt from 1933 or 1934 Act registration does not affect the applicability of Rule 10b's proscriptions. The rule applies regardless of whether the security is registered under the 1934 Act, and regardless of whether the company is publicly held or closely held. It applies even to government and municipal securities, and, in fact, to any kind of entity that issues something which can be called a "security." Because of this broad scope, Rule 10b-5 can be invoked in many situations.

In order for a misstatement or omission to be actionable under Rule 10b-5, it must be material. The Supreme Court has defined materiality in

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F. Supp. 979 (E.D. Pa. 1987) (upholding Rule 10b-5 claim challenging broker's system for disbursing proceeds from sale); Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143 (D.D.C. 1986) (sufficient causal connection based on alleged misstatements dissuading employees from delaying retirement, which triggered a sale of stock under stock bonus plan).

292. Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Mader v. Armel, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

293. *In re* Penn Cent. Sec. Litig., 494 F.2d 528 (3d Cir. 1974).

294. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

295. *E.g.*, Madison Consultants v. FDIC, 710 F.2d 57 (2d Cir. 1983); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979). *See also* Rubin v. United States, 449 U.S. 424 (1981) (decided under § 17(a) of the 1933 Act).

296. Lincoln Nat'l Bank v. Herber, 604 F.2d 1038 (7th Cir. 1979); National Bank v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978).

297. Falls v. Fickling, 621 F.2d 1362 (5th Cir. 1980); Bosse v. Crowell Collier, & MacMillan, 565 F.2d 602 (9th Cir. 1977).

terms of the type of information that a reasonable investor would consider significant in making an investment decision.[298] The materiality of a particular item is determined within the total mix of information that is publicly available. As materiality questions are highly fact-specific, summary judgment will rarely be appropriate.[299]

Following the common law of fraud, reliance is an element of any Rule 10b-5 claim. The Supreme Court, in a split decision, recognized the fraud-on-the-market presumption of reliance,[300] under which a showing that a material misstatement or omission adversely affected the market price creates a presumption of reliance. However, the availability of the presumption is premised on the existence of a relatively liquid and, hence, efficient market for the securities in question.[301] The defendant may rebut the presumption of reliance or show that reliance was unreasonable.

Causation is a key element of a Rule 10b-5 action. Many courts have divided causation into two subparts: transaction causation and loss causation. Transaction causation requires a showing that but for the violations in question, the transaction would not have occurred (at least in the form that it took). Loss causation requires a showing of a causal nexus between the transaction and the plaintiff's loss.[302] Also, as is the case with any fraud claim, the plaintiff must be able to establish damages. In most Rule 10b-5 litigation, the appropriate measure of damages is the out-of-pocket loss caused by the material misstatement or omission.[303] On occasion, dis-

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298. Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (decided under Rule 10b-5); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (decided under the proxy rules).

299. For examples of materiality in various contexts, see Thomas Hazen, Treatise on the Law of Securities Regulation § 13.5 (2d ed. 1990).

300. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). *See, e.g.*, Finkel v. Docutel/Olivetti Corp., 817 F.2d 356 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988). *See also* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) (applying presumption of reliance in face-to-face transaction).

301. *See, e.g.*, Freeman v. Laventhol & Horwath, 915 F.2d 193 (6th Cir. 1990); Greenberg v. Boettcher & Co., 755 F. Supp. 776 (N.D. Ill. 1991); Sanders v. Robinson Humphrey/Am. Express, Inc., 634 F. Supp. 1048 (N.D. Ga. 1986), *modified on other grounds sub nom.*; Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718 (11th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); Reingold v. Deloitte Haskins & Sells, 599 F. Supp. 1241 (S.D.N.Y. 1984).

302. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.6.4 (2d ed. 1990).

303. *E.g.*, Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987); Harris v. Union Elec. Co., 787 F.2d 355, 367 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986).

gorgement of ill-gotten profits or the benefits of the bargain might be a more appropriate measure of damages.[304]

Section 10(b) and Rule 10b-5 do not contain a statute of limitations for the implied remedy. Under the earlier decisions, the applicable statute of limitations for antifraud claims was generally the most analogous state statute of limitations.[305] Many courts held this to be the "blue sky" limitations period.[306] Regardless of the applicable statute of limitations, the decisions formerly held that federal equitable tolling principles were applicable, so that the statute of limitations did not begin to run until the time the violation was discovered or reasonably should have been discovered. In contrast, section 13 of the 1933 Act provides the statute of limitations applicable to private actions under the Act: one year from the date of discovery, with a three-year repose period. In other words, no claim can be brought more than three years after the sale or violation.[307] A similar one-year/three-year limitations period applies to express remedies under sections 9(e) and 18(a) of the 1934 Act.[308] The Supreme Court, in a splintered 5-4 decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[309] held that the applicable limitations period was to be found in the most analogous federal (rather than state) statute. Accordingly, the Court applied the one year from discovery/three-year repose period.[310] Although the Court applied the new rule retroactively, Congress has since attempted to legislatively overrule the Court by denying retroactive application of the *Lampf* decision. This legislation has been enacted while Congress continues to consider a longer

304. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.7 (2d ed. 1990).

305. *See id.* § 13.8.

306. *Id.* Especially in earlier decisions, some courts applied the longer common-law fraud limitations period. A blue sky law is a state securities act.

307. In an action under § 12(2) of the 1933 Act, the three-year repose period runs from the sale; in an action under § 11 or § 12(1), the three years begin to run from the time the securities were first bona fide offered to the public.

308. In contrast, an action for disgorgement of profits from insider short-swing transactions has a two-year limitations period. 1934 Act § 16(b).

309. 111 S. Ct. 2773 (1991). In so ruling, the Court followed its earlier decision in Agency Holding Corp. v. Malley-Duff Assoc., Inc., 107 S. Ct. 2759 (1987), holding that in a private RICO action the statute of limitations was to be taken from the federal antitrust laws rather than the most analogous state limitations period.

310. 111 S. Ct. 2773 (1991). In *In re* Data Access Sys., 843 F.2d 1537 (3d Cir. 1988), the Third Circuit held that the *Agency Holding* rationale is equally applicable to the federal securities laws. As such, the court applied § 18(a)'s one-year/three-year limitations period.

statute of limitations for Rule 10b-5 actions.[311] Section 27A(b) provides for the reinstatement of all claims initiated prior to *Lampf* that had been dismissed based on retroactive application of that decision. Although most cases are to the contrary, some courts have ruled that the separation-of-powers doctrine dictates that Congress may not interfere with the vested rights of the parties in a final judgment dismissing a claim in reliance on the *Lampf* ruling.[312]

Even beyond the issue of retroactive application of the new limitations period, a number of questions remain unanswered. For example, does the three-year repose period start with the sale or the violation?[313] The answer

311. Section 27A. In contrast to the one-year/three-year statute, the new remedy for illegal insider trading contains a five-year limitations period which runs from the date of the transaction. Section 20A(b)(4).

312. The following cases have refused to apply § 27A: Bank of Denver v. Southeastern Capital Group, Inc., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,615 (D. Colo. 1992); Johnston v. Cigna Corp., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,616 (D. Colo. 1992); Mancino v. International Tech. Corp., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,614 (C.D. Cal. 1992); *In re* Brichard, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,598 (N.D. Cal. 1992); Simmons v. Templeton, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,590 (E.D. La. 1992).

The following are some of the cases which have held that § 27A(b) is not constitutionally infirm: Cooke v. Manufactured Homes, No. 93-1005, 1993 WL 248257 (4th Cir. July 9, 1993); Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co., 993 F.2d 269 (1st Cir. 1993); Gray v. First Winthrop Corp., 989 F.2d 1564 (9th Cir. 1993); Berning v. A.G. Edwards & Sons, Inc., 990 F.2d 272 (7th Cir. 1993); Anixter v. Home-Stake Prod. Co., 977 F.2d 1533 (10th Cir. 1992); Henderson v. Scientific Atlanta, Inc., 971 F.2d 1567 (11th Cir. 1992); Henley v. Slone, 961 F.2d 23 (2d Cir. 1992); Fred Hindler, Inc. v. Telequest, Inc., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,634 (S.D. Cal. 1992); Brown v. Hutton Group, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,624 (S.D.N.Y. 1992); TBG Inc. v. Bendis, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,623 (D. Kan. 1992); Axel Johnson, Inc. v. Arthur Andersen & Co., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,618 (S.D.N.Y. 1992); First v. Prudential Bache Sec., Inc., [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,622 (S.D. Cal. 1992); Venturetech II v. Deloitte Haskins & Sells, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,610 (E.D.N.C. 1992); Ayers v. Sutliffe, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,552 (S.D. Ohio 1992).

313. The three-year period in a § 9(e) action begins to run from the date of the violation; in an action under § 18(a), the three-year repose period runs from the time the cause of action "accrues." In contrast, under the 1933 Act, the three-year period runs from the date of the sale or from the time the security is first bona fide offered

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would determine whether a continuing fraud could toll the statute beyond the three-year repose period.

In *Herman & MacLean v. Huddleston*,[314] the Supreme Court held that the remedies under section 11 of the 1933 Act for misstatements in registration materials and Rule 10b-5 are cumulative. Presumably, Rule 10b-5 remedies are cumulative with other express remedies as well.[315]

Secondary liability. In addition to primary liability of persons who violate the securities laws, there can be secondary liability of collateral participants. There are three types of secondary liability: (1) controlling person liability; (2) vicarious liability based on *respondeat superior*; and (3) liability for aiding and abetting a primary violator.

The first requirement for imposing secondary liability on a collateral participant is the identification of a primary violation of the securities laws. Recall that under the 1933 Act, there are three express remedies, each of which specifically lists the potential defendants.[316] Additionally, section 15 of the 1933 Act expressly provides that someone who controls a primary violator may be liable as a controlling person. In contrast to the 1933 Act provisions, Rule 10b-5 applies to "any person" who makes a material misrepresentation in connection with the purchase or sale of a security. It is virtually universally accepted that the broad reach of the rule leaves room for aiding and abetting liability[317] as well as controlling person liability.

Controlling person liability[318] is found in section 15 of the 1933 Act and section 20(a) of the 1934 Act. This liability requires that the defendant not only be a controlling person of the primary violator but also a culpable participant in the illegal activity. In an employment context, failure to su-

to the public, depending on whether the claim is based on § 12(2) or on § 11 or 12(1).

314. 459 U.S. 375 (1983).

315. Remedies under §§ 12(1) and 12(2) of the 1933 Act. The measure of damages under § 12 of the 1933 Act is based on rescission. See also the remedy under § 18(a) of the 1934 Act (misstatements in false filings). The new remedies under the Insider Trading and Securities Fraud Sanctions Act of 1988, codified in § 21A of the 1934 Act (disgorgement of profits in an action by contemporaneous traders), are expressly in addition to any other express or implied remedies.

316. 1933 Act § 11(a) imposes liability on signers of the registration statement and experts. 1933 Act § 12 imposes liabilities on sellers.

317. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.16 (2d ed. 1990).

318. The securities laws give a very broad definition of control, *e.g.*, Rule 405: "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise."

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pervise an employee may be deemed indirect participation by the controlling person, and thus the controlling person may be liable for any fraudulent schemes arising during the unsupervised period. Controlling person liability is not limited to an employer–employee relationship.

Controlling person liability is more restrictive than common-law agency theories in that it holds a controlling person liable only if that person (1) did not act in good faith or (2) induced or knowingly participated in the violation. Controlling person liability is broader than *respondeat superior* in that it is not limited to employers. The question has arisen as to whether controlling person liability is exclusive. Most circuit courts have held that section 20(a) of the 1934 Act is not an exclusive remedy and thus can be supplemented by common law principles of *respondeat superior*.[319] In contrast to the prevailing rule as to controlling person liability generally, section 21A(b)(2) denies *respondeat superior* liability in actions dealing with insider trading.[320]

Courts generally recognize the availability of aiding and abetting liability for violations of the antifraud provisions of the 1934 Act,[321] although it is not expressly included in the statute. Aiding and abetting liability requires a showing of the following:

1. the existence of a securities law violation by the primary party;
2. "knowledge" of the violation on the part of the aider and abettor; and
3. "substantial assistance" by the aider and abettor in the achievement of the primary violation.[322]

Most courts hold that as a general proposition, the aider and abettor must have acted with at least the same degree of scienter as the primary vio-

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319. Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991); *In re* Atlantic Fin. Mgmt., Inc., 784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987); Henricksen v. Henricksen, 640 F.2d 880, 887 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980). *But see* Carpenter v. Harris, Upham & Co., 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

320. The Insider Trading and Securities Fraud Enforcement Act of 1988 provides that there is no controlling person liability under the Insider Trading Sanctions Act of 1984 unless it is shown that the controlling person knew or recklessly disregarded the likelihood of illegal trading on inside information and failed to take precautions against the illegal conduct. 1934 Act § 21A(b).

321. Analogous to an aiding and abetting claim is the allegation that a collateral participant was part of a conspiracy to violate the Act.

322. *See, e.g.*, Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

lator.[323] However, when the aider and abettor stands in a fiduciary relationship to the plaintiff, recklessness will satisfy the scienter requirement for imposing liability on one for aiding and abetting.[324]

RICO in Securities Cases

The Racketeer Influenced and Corrupt Organizations Act (RICO) was enacted in 1973 to help eradicate organized crime.[325] RICO is drafted in general terms and thus has a broad reach. Among other things, it provides a treble damage remedy to anyone injured by a person associating with an "enterprise" and engaging in "a pattern of racketeering." An "enterprise" consists of any association, formal or informal[326]—it need not be a permanent association.[327] The Supreme Court has indicated that the enterprise requirement is a separate element from the "pattern of racketeering activity" even though the facts pertaining to each may coalesce.[328]

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323. *See* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 495 (7th Cir. 1986) ("We take *Ernst & Ernst*, together with *Herman & Maclean*, as establishing that aiders, abettors, conspirators, and the like may be liable only if they have the same mental state required for primary liability.").

324. The Sixth Circuit, in Herm v. Stafford, 663 F.2d 669, 684 (6th Cir. 1981), held that recklessness will satisfy the scienter requirement even in the absence of a fiduciary relationship. *But see, e.g.*, *In re* Union Carbide Corp. Consumer Prods. Business Sec. Litig., 676 F. Supp. 458 (S.D.N.Y. 1987) (actual knowledge is required where the alleged aider and abettor does not stand in a fiduciary or confidential relationship to the injured party). Brokers are frequently held to stand in a special fiduciary relationship to their customers. The existence of this fiduciary duty does not eliminate the scienter requirement; it merely affects the degree of scienter necessary to find one guilty of aiding and abetting. If no fiduciary duty exists, then the scienter standard will be stricter. *See* Harmsen v. Smith, 693 F.2d 932, 944 n.10 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983).

325. 18 U.S.C. §§ 1961–1968 (1988 & Supp. 1990). Many states have enacted "little RICO" statutes.

326. 18 U.S.C. § 1961(4) (1988). According to the Supreme Court, the concept of enterprise connotes a group with a common purpose, a continuity of personnel, and an ongoing formal or informal organization. United States v. Turkette, 452 U.S. 576 (1981). *See also, e.g.*, Northern Ky. Bank & Trust v. Rhein, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,864 (E.D. Ky. 1984) (it is not necessary to delineate the structure of the enterprise at the pleading stage).

327. *See, e.g.*, United States v. Turkette, 452 U.S. 576 (1981), where the Court applied the term to a band of hooligans who had a one-night rampage of murder and other acts covered by RICO.

328. United States v. Turkette, 452 U.S. 576 (1981). *See also* Police Retirement Sys. v. Midwest Inv. Advisory Serv., Inc., 706 F. Supp. 708 (E.D. Mo. 1989) (enterprise requirement was satisfied but no pattern of racketeering activity shown).

In addition to the enterprise requirement, a violation of RICO section 1962 requires a "pattern of racketeering activity."[329] A "pattern of racketeering" requires two or more underlying predicate acts, as defined by section 1961(1), occurring within ten years of each other.[330] Securities fraud is expressly included as one of the underlying predicate acts. Fraud and mail fraud are also included as predicate acts. Thus, it is not necessary that a security be involved; fraud relating to other types of investments may be covered by RICO. The Supreme Court has held that RICO does not require multiple schemes to find a pattern of racketeering. Furthermore, in order to satisfy the pattern-of-racketeering requirement, the multiple predicate acts must be arranged or ordered either by the relationship they bear to one another or by the relationship that the predicate acts bear to some external organizing principle.[331]

The treble damage provision and availability of attorneys' fees make RICO counts attractive in appropriate securities cases.[332] A RICO action can be brought in either federal or state court.[333] RICO has been applied in securities cases, for example, where a broker–dealer (i.e., enterprise) engages in more than one fraudulent act.

Mail and Wire Fraud

The federal Mail Fraud Act[334] and the federal Wire Fraud Act[335] can be potent alternative weapons in the enforcement of securities law. For example, while the Supreme Court was equally divided over criminal convictions under the securities laws for trading on confidential information, the Court unanimously decided that the conduct violated the Mail Fraud Act.[336] A violation of the Mail Fraud or Wire Fraud Acts requires only the use of the mails or wires to execute a scheme to defraud someone of his or her property rights, tangible or intangible.[337] As long as the mails or electronic transmissions are used, the Mail Fraud and Wire Fraud Acts "reach any scheme to deprive another of money or property by means of false or

329. 18 U.S.C. § 1962 (1988).

330. *See* 18 U.S.C. § 1961(5) (1988).

331. H.J., Inc. v. Northwestern Bell Tel. Co., 492 U.S. 229 (1989).

332. RICO also permits forfeiture of attorneys' fees that were paid with money made by the client from racketeering activities. This provision has been used for drug dealers but presumably could also be used with securities law violations.

333. Yellow Freight Sys. v. Donnelly, 494 U.S. 820 (1990)

334. 18 U.S.C. § 1341 (1988 & Supp. 1990).

335. 18 U.S.C. § 1343 (1988 & Supp. 1990).

336. Carpenter v. United States, 484 U.S. 19 (1987).

337. *Id.* at 25–28. The Court specifically declared that "[c]onfidential business information has long been recognized as property." *Id.* at 26.

fraudulent pretenses, representations, or promises."[338] This may be relevant in both criminal and civil actions. Although there is no specific civil liability for violation of mail fraud and wire fraud statutes, such violations are predicate acts under RICO, which can lead to treble damages.

Insider Trading

Rule 10b-5

Perhaps the most common and widely known usage of Rule 10b-5 is in the context of "insider trading," or trading on the basis of nonpublic confidential or proprietary information. Trading on inside information destroys the integrity of the marketplace by giving an informational advantage to a select group of corporate insiders. Rule 10b-5 is the primary source of liability for improper trading on inside information.[339] There are essentially two varieties of improper trading on the basis of nonpublic information. One is a face-to-face transaction in which an insider fails to disclose material information to the buyer or seller. This not only involves a clear violation of Rule 10b-5[340] but also violates principles of common law fraud.[341] The second variety, which forms the basis of the overwhelming majority of litigation under the securities laws, involves open-market transactions by corporate insiders and others in possession of material nonpublic information.

As there is no statutory definition of what constitutes improper trading on nonpublic information, the 1934 Act's catchall provision in Rule 10b-5 is the primary source of the violation. Over time, there has been a change in the premise of insider trading liability under Rule 10b-5 from one of unfairness to investors[342] to one of fiduciary duty and misappropriation.[343] Rule

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338. *Id.* at 27.

339. Promulgated by the SEC in 1942, Rule 10b-5 is patterned directly on § 17(a) of the 1933 Act. The primary difference is that Rule 10b-5 extends to misstatements or omissions occurring in connection with either a purchase or sale of securities, whereas § 17(a) is limited to fraudulent sales. The assistant solicitor of the SEC, Milton Freeman, who formulated Rule 10b-5 in response to a fraudulent purchase of corporate securities by the company's president, describes the drafting and adoption of the rule in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman).

340. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

341. *See, e.g.*, Strong v. Repide, 213 U.S. 419 (1909).

342. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.9 (2d ed. 1990).

343. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980). In *Chiarella*, Justice Powell explained the development of Rule 10b-5:

10b-5(3) makes it unlawful for "any person, directly or indirectly, by the use of any instrumentality of interstate commerce . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the sale or purchase of any security." The violation is thus premised on fraud and the existence of some duty to speak honestly. Silence alone is not actionable; there must be a duty to speak. Possession of inside information without more does not create the duty to speak or abstain from trading under Rule 10b-5.[344] Subsequent judicial treatment of this requirement has led to the misappropriation theory, and the concept of the "constructive" or "temporary" insider who, though not strictly speaking an insider, nevertheless owes some fiduciary duty to the person who discloses to him or her the material nonpublic information he or she "misappropriates."

Beginning in 1961, the SEC broadened the application of Rule 10b-5 into a general prohibition on corporate officials trading on the basis of material nonpublic information, even on the open market.[345] This expansion

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> In Cady, Roberts & Co., 40 S.E.C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him.
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> The obligation to disclose or abstain derives from:
>
> "[a]n affirmative duty to disclose material information[, which] has been traditionally imposed on corporate 'insiders,' particular officers, directors, or controlling stockholders. We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."
>
> The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. *Id.*, at 912, and n.15. . . . In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders." Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

445 U.S. at 226–29.

344. Chiarella v. United States, 445 U.S. 222 (1980).

345. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). *See also, e.g., In re* Smith Barney, Harris, Upham & Co., Exchange Act Release No. 34-21242 [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,656 (Aug. 15, 1984) (brokerage firm should give its customers time to digest research recommendations reflecting a material change in the firm's position before the firm trades in securities for its own account). *But see* Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S.

stemmed from the view that the harm the rule sought to protect against was unfairness to investors not privy to the inside information, so that the potential trader possessing material nonpublic information had an alternative duty to disclose the information or to abstain from trading.[346] In the first Supreme Court case on point, the Court held that in a face-to-face transaction, a purchaser possessing inside information about a company has a duty to disclose such information to the seller before consummating the transaction.[347] More recently, however, the Court held that in order to find a violation of Rule 10b-5, the plaintiff must show that the defendant had material nonpublic information and a legal duty, based on a wrongful conversion or misappropriation of the information, to disclose it.[348]

In *Chiarella v. United States*,[349] the Supreme Court held that a Rule 10b-5 claim cannot be based solely on the defendant's knowingly trading to his or her advantage while in possession of material nonpublic information.[350] However, a number of the justices indicated that a conviction could stand if based on a theory that the defendant was given information in a position of trust and then wrongfully misappropriated the information to his or her advantage.

A recent Second Circuit decision is illustrative of the problem of defining insider trading. In *United States v. Chestman*,[351] a stockbroker's customer

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1025 (1984) (brokerage firm not held liable to open market seller). SEC Rule 14e-3 is another source of insider trading prohibitions, but its application is limited to tender offers.

346. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

347. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

348. Chiarella v. United States, 445 U.S. 222 (1980).

349. *Id.* In this case, the defendant was the employee of a printing company involved in the production of various tender offer documents. The target company's name was concealed in the galleys sent to the printer in an effort to maintain confidentiality. However, Chiarella was able to identify the company based on the other information in the tender offer material, and with this knowledge, he traded in securities of the target company for profit. The Court reversed his conviction on the ground that he had no legal duty to speak.

350. Such a definition has been proposed to Congress but has not been adopted. However, following the *Chiarella* decision, the SEC adopted Rule 14e-3, which makes it unlawful for anyone other than the tender offeror who has knowledge of a planned tender offer to trade on that information.

351. 704 F. Supp. 451 (S.D.N.Y. 1989), *rev'd*, 903 F.2d 75 (2d Cir. 1990), *reh'g en banc*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

relayed to the broker information about an impending takeover.[352] The broker, armed with that knowledge, purchased shares in the target company and subsequently was indicted for violating Rules 14e-3 and 10b-5, and mail fraud. The jury found the broker guilty on all counts. The broker appealed, and in three separate opinions, a panel of the Second Circuit reversed the broker's convictions on all counts.[353] The Second Circuit then agreed to rehear the case en banc,[354] and the Rule 14e-3 conviction was affirmed while the Rule 10b-5 and mail fraud convictions were reversed. However, these decisions were reached as a result of many separate opinions.[355] In affirming the broker's Rule 14e-3 convictions, ten of the eleven judges rejected the broker's arguments that (1) Rule 14e-3 was invalid, or that, if not, there was insufficient evidence to sustain the convictions; and (2) that his convictions violated the "fair notice" requirement of due process. However, the Rule 10b-5 convictions (as well as the mail fraud convictions) were reversed because six of the judges found that no fiduciary duty had been breached.[356] As a result, it appears in the Second Circuit that at least in the context of public tender offers, the SEC has filled the gap left by the decision in *Chiarella*, as no fiduciary duty is required for a conviction under Rule 14e-3.

While the Supreme Court has not expressly ruled on the misappropriation theory, there is strong evidence that the Court accepts at least the principles behind the theory. For example, in *Dirks v. SEC*[357] the Court indi-

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352. The customer, Mr. Loeb, was married to the granddaughter of Julia Waldbaum, a member of the board of directors of Waldbaum, Inc., a publicly traded company that owned a large supermarket chain. Furthermore, Mrs. Loeb's uncle, Ira Waldbaum, was president and controlling shareholder of Waldbaum, Inc. The customer related to the broker nonpublic information he had learned, as a result of being a Waldbaum family member, about an impending sale of Waldbaum to the Great Atlantic and Pacific Tea Company.

353. 903 F.2d 75 (2d Cir. 1990).

354. 947 F.2d 551 (2d Cir. 1991).

355. Five judges voted to affirm the Rule 14e-3 convictions and reverse the Rule 10b-5 and mail fraud convictions (with one judge writing a special concurrence); five judges voted to affirm all convictions, and one judge voted to reverse all convictions.

356. A recent case showing the potential for liability under this view is United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990). A former CEO of Shearson and former President of American Express was considering becoming CEO of BankAmerica. He discussed these plans with his wife, who in turn discussed them with her psychiatrist in the course of her treatment. The psychiatrist traded in the marketplace on the basis of this material nonpublic information and profited as a result. On the basis of the breach of the fiduciary relationship between the psychiatrist and his patient, the court held that the psychiatrist had violated Rule 10b-5.

357. 463 U.S. 646 (1983).

cated that someone who receives information from an insider (or anyone else holding that information in trust) is not liable under Rule 10b-5 for trading on that information unless that insider passed on that information with some wrongful motive.[358] Thus in the absence of some breach of fiduciary duty, or "misappropriation," there is no violation of Rule 10b-5. The Court also suggested that for liability to attach, there must be "personal gain" by the wrongdoer.[359] However, subsequent case law suggests that this may no longer be true. The misappropriation theory again reached the Supreme Court in 1987.[360] The defendant was a financial columnist (writing the influential *Wall Street Journal*'s "Heard on the Street" column) who had tipped his friends in advance as to the contents of upcoming columns that would affect the price of certain stocks. The Second Circuit held that the information had been misappropriated from the defendant's employer (Dow Jones), and thus, under the disclose or abstain rule, the columnist and his friends had violated Rule 10b-5.[361] This decision was affirmed without opinion by an equally divided Supreme Court.[362] It remains to be seen whether the Court was divided over the validity of the misappropriation theory in general or on some other issues raised by the case.[363] Thus, until rejected by the Court, the misappropriation theory remains good law.

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358. In *Dirks*, the insiders were former employees of the company at issue. Their motivation in disclosing the information to Dirks, a security analyst, was a desire to expose the company's fraud. While attempting to verify that a fraud had in fact occurred, Dirks disclosed the information to some of his institutional customers, who thereupon sold large quantities of stock in the company. The Court found that Dirks was not an insider and that he did not owe a duty to the insiders not to disclose the information (in fact, they wanted him to). Since the insiders who did pass the information to him did not have a wrongful motive, Dirks was not obligated to abstain from passing on the inside information disclosed to him.

359. *Dirks*, 463 U.S. at 660.

360. Carpenter v. United States, 484 U.S. 19 (1987).

361. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

362. Carpenter v. United States, 484 U.S. 19 (1987). Note that the decision to recognize the misappropriation theory also finds support in the legislative history of the 1988 Insider Trading and Securities Fraud Enforcement Act (ITSFEA), H.R. Rep. No. 100-910, 100th Cong., 2d Sess. 10–11 (1988).

363. For example, the Court may have been divided over the question of whether Rule 10b-5's "in connection with" requirement had been satisfied. Rule 10b-5(3) requires conduct that would operate as a fraud upon "any person." The question becomes whether the "in connection with" requirement means that such a person must have been a purchaser or seller. This was not required by the Second Circuit. In *Carpenter*, the reporter's employer from whom the information was allegedly misappropriated was neither a purchaser nor a seller of securities. The SEC

Insider Trading Sanctions

SEC Actions

Willful violations of the federal securities laws may give rise to a criminal prosecution resulting in fines and/or imprisonment. Furthermore, violations may result in sanctions from the Commission. For example, the Commission may impose administrative sanctions: If the violator is a broker–dealer or other market professional, his license can be suspended or revoked. By virtue of section 21(d)(1) of the 1934 Act, the SEC is authorized to seek either temporary or permanent injunctive relief in the courts "whenever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices which constitute or will constitute a violation."

Although the statutory enabling provisions speak solely in terms of the SEC's power to enjoin, the SEC and the courts have fashioned remedies ancillary to the traditional injunctive decree relying on "the general equitable powers of the federal courts."[364] Ancillary relief has taken many forms, ranging from disgorgement of ill-gotten profits to more imaginative corrective action. Among such "imaginative" remedies are the appointment of an independent majority on the board of directors,[365] the appointment of a receiver,[366] prohibitions against exercising voting control in a proxy battle,[367] the appointment of "special professionals" to assure compliance with securities laws,[368] orders designed to protect remaining assets,[369] and

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argued that if the conviction were to be overturned it should be overturned on these grounds rather than on a wholesale rejection of the misappropriation theory.

364. *See, e.g.*, James Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 Harv. L. Rev. 1779, 1781 (1976).

365. *See, e.g.*, SEC v. Vesco, 571 F.2d 129 (2d Cir. 1978); SEC v. Mattel, Inc., [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807 (D.D.C. 1974) (consent to sanctions).

366. *See, e.g.*, SEC v. United States Fin. Group, Inc., 474 F.2d 354 (9th Cir. 1973); SEC v. Florida Bank Fund, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707 (M.D. Fla. 1978). This power is expressly given to the Commission by § 42(e) of the Investment Company Act for violators of the Act's registration requirements. 15 U.S.C. § 80a-41(e) (1988 & Supp. 1990).

367. *See, e.g.*, SEC v. Westgate Cal. Corp., SEC Litigation Release No. 6142, 3 SEC Docket 30 (S.D. Cal. Nov. 9, 1978). *Cf.* Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (defendant barred from voting for five years on shares obtained illegally).

368. *See, e.g.*, SEC v. Beisinger Indus. Corp., 552 F.2d 15 (1st Cir. 1977); SEC v. First Jersey Sec., Inc., [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,923 (S.D.N.Y. 1985) (appointment of consultant to review broker–dealer's practices, pursuant to permanent injunction entered by parties' consent).

prohibitions of continued participation as an officer or director of any public company.[370]

In the wake of the *Chiarella*[371] and *Dirks*[372] decisions, Congress enacted even stronger insider trading penalties, available for use by the SEC. The Insider Trading Sanctions Act of 1984 (ITSA) increased civil and criminal penalties for trading while in possession of material nonpublic information: The SEC is authorized to seek disgorgement of profits and a civil penalty of up to three times the profits gained or the loss avoided by the defendant, and the criminal penalty has been increased from $10,000 to $100,000. However, while facially applicable to transactions involving misuse of nonpublic material information, ITSA does not define the scope of permissible conduct. Thus it does not alter the availability of a cause of action, merely the penalties that may be imposed. Nevertheless, ITSA has proven to be an effective enforcement weapon. Following its enactment, the SEC has been increasingly vigorous in enforcing insider trading prohibitions and has reached some lucrative settlements.[373]

The question arises whether actions under ITSA and criminal prosecutions based on the same transactions violate the constitutional prohibition against double jeopardy. A recent Supreme Court decision sheds light on this issue. In *United States v. Halper*,[374] the defendant was convicted of violations of the criminal false claims statute and the Mail Fraud Act. The defendant was then sued by the government under the Civil False Claims Act. The district court imposed civil fines totaling $130,000. On review, the Supreme Court found that a civil penalty may be so unrelated to the reme-

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369. *See, e.g.*, SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1105–06 (2d Cir. 1972); SEC v. R.J. Allen & Assoc., 386 F. Supp. 866, 881 (S.D. Fla. 1974). *See also* SEC v. Vaskevitch, 657 F. Supp. 312 (S.D.N.Y. 1987) (freeze order in insider trading case); SEC v. American Board of Trade, Inc., 830 F.2d 431 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988) (freeze order in illegal unregistered commercial paper investment program).

370. *See, e.g.*, SEC v. Cosmopolitan Inv. Funding Co., SEC Litigation Release No. 7366 (April 23, 1976); 42 SEC Ann. Rep. 119 (1976).

371. 445 U.S. 222 (1980).

372. 463 U.S. 646 (1983).

373. *See, e.g.*, SEC v. Certain Unknown Purchasers of Common Stock and Call Options of Santa Fe Int'l Corp., [1985–1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,484 (S.D.N.Y. 1986) (consent order to disgorge $7.8 million in alleged insider trading profits); SEC v Boesky, [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986) (settlement of $50 million disgorgement and $50 million penalty); SEC v. Kidder Peabody & Co., 19 Sec. Reg. & L. Rep. (BNA) 811 (S.D.N.Y. 1987) (settlement of more than $25 million).

374. 109 S. Ct. 1892 (1989).

dial goals of the statute that it constitutes "punishment" within the meaning of the double jeopardy clause of the Constitution. The *Halper* decision thus establishes that double jeopardy issues can arise when a criminal prosecution is followed by a government suit seeking to impose civil penalties.

In *Halper*, the Court took care to point out that its holding does not apply to situations in which there has been no prior criminal prosecution. Moreover, the Court did not address the situation in which the criminal prosecution follows the imposition of a civil penalty. However, under the Court's rationale, it appears that if the civil penalty is large and unrelated to remedial purposes, it may be a "punishment," thereby preventing any subsequent criminal prosecution.

The Court in *Halper* noted that there are no double jeopardy problems associated with a criminal prosecution followed by a civil suit brought by a private party. Likewise, the double jeopardy problem does not arise when the civil and criminal penalties are brought in a single proceeding. Thus, the implications of the *Halper* decision should spur the SEC to consider seeking civil and criminal sanctions in a single proceeding, a change from its current policy of going after defendants in a piecemeal fashion.

Private Rights of Action for Insider Trading

In a face-to-face transaction, an action will lie against someone who sells or purchases while in possession of material nonpublic information.[375] However, in an open-market context, standing to sue is more problematic. In a Ninth Circuit case,[376] a financial columnist who purchased stock prior to publishing his buy recommendation was held liable to a "forced purchaser"—someone did not make an investment decision and therefore did not rely on the column.[377] The recommendation was based on an overly optimistic view of the company. The court reasoned that the defendant's failure to disclose defrauded the market by causing an artificially high price that the plaintiffs were forced to pay.

The fraud-on-the-market theory, however, is far from unanimously accepted in the insider trading context. The Sixth Circuit has held that any duty that was breached was owed to the person from whom the information

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375. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972). Causation was not a problem because the purchaser dealt directly with the seller. Further, the Court held that reliance on the nondisclosure could be presumed from the materiality of the information.

376. Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979).

377. The plaintiffs acquired the stock pursuant to a merger that was agreed to prior to the conduct in question.

was appropriated, not to someone in a faceless market.[378] Similarly, the Second Circuit has held that a tippee of inside information who was convicted of having violated Rule 10b-5 was not liable to people who were selling their stock at the same time that the defendant was buying on inside information; instead, the person trading on the information must be a corporate official who owes an independent duty to the shareholders who trade on opposite sides of the insiders' transactions.[379]

The Insider Trading and Securities Fraud Enforcement Act (ITSFEA) of 1988 was designed by Congress to supplement any remedy that may exist under Rule 10b-5. It provides an express private right of action by contemporaneous traders against persons making improper use of material nonpublic information.[380] Damages in such an action are limited to the profit (or loss avoided) that is attributable to the defendant's illegal conduct, reduced to the extent that the SEC has secured disgorgement (as opposed to penalty) under the 1984 ITSA legislation.

ITSFEA also specifically addresses controlling person liability.[381] Such liability in a private suit is still governed by section 20(a) of the 1934 Act. However, ITSFEA imposes a more specific provision for controlling person liability in SEC actions under ITSA. Under ITSFEA, a court can impose ITSA penalties on a controlling person of a primary violator only if (1) the controlling person knew or acted in reckless disregard of the fact that the controlled person was likely to engage in illegal insider trading, and (2) the controlling person failed to take adequate precautions to prevent the prohibited conduct from taking place. The establishment of a "Chinese Wall" or "fire wall" to keep confidential information confined to the proper sectors of a multiservice firm will protect against controlling person liability.

In a further attempt to provide incentive for private persons to expose illegal insider trading, ITSFEA also contains a "bounty" provision. Section 21A(e) states that up to 10% of any civil penalty recovered by the SEC may, at the SEC's discretion, be paid to the private individuals who provided information leading to the imposition of the penalty. Persons associated with

378. Friedrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

379. Moss v. Morgan Stanley, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

380. 1934 Act § 20A.

381. Controlling person liability under the Exchange Act generally is governed by § 20(a) of the Act. In addition to the new controlling person provision, the 1988 legislation was amended to make it clear that tippers and tippees are both primary violators, so plaintiffs need not rely on aiding and abetting principles. 1934 Act § 20A(c).

the Commission, the Department of Justice, or the self-regulatory organizations are not eligible to receive a bounty reward.

In October 1990, Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act. This act gave the SEC the power in an administrative proceeding to require disgorgement of illegal profits.[382]

Insider Transactions and Section 16

Section 16[383] of the Exchange Act regulates directors, officers, and 10% (or greater) beneficial owners of any class of equity securities subject to section 12 registration requirements. This provision is designed to discourage corporate "insiders" from taking advantage of their access to information by engaging in "short-swing" trading.[384]

Transactions by Officers, Directors, and 10% Beneficial Owners—Sections 16(a) and 16(b)

Persons falling within the scope of section 16 (i.e., an officer, director, or 10% beneficial owner of a class of equity securities subject to the 1934 Act reporting requirements) are required to file appropriate notice with the Commission, including disclosure of all ownership interest in any of the issuer's equity securities, within ten days of acquiring that status.[385] Thereafter, whenever they acquire or dispose of any equity securities of the company, they must file notice thereof with the Commission within ten days of the end of the calendar month in which the change takes place.[386]

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382. These amendments also require additional disclosures about "penny stocks." Penny stocks are securities that are generally unlisted, non-NASDAQ, over-the-counter stocks and are sold at under $5 a share. These stocks are frequently subject to abuse because (1) they can be sold in large volume, frequently to unsophisticated investors, generating enormous profits for unscrupulous broker–dealers; (2) they are usually issued by smaller, little-known companies that attract little attention outside that generated by the offering broker–dealer; and (3) there is no reliable quotation system for the non-NASDAQ OTC market, providing an opportunity for decreased supervision and increased abuse. *See* Exchange Act Release No. 27,160 (Aug. 22, 1989).

383. Section 16(a) contains reporting requirements, § 16(b) imposes liability for short-swing profits, and § 16(c) prohibits insider short sales.

384. "Short-swing" trading is short-term trading in the corporation's stock (in the statute, a purchase then sale or sale then purchase occurring within six months). The potential for abuse of material confidential information by corporate "insiders" to turn a quick profit by short-swing trading was found by Congress to be very serious.

385. 1934 Act § 16(a).

386. *Id.* Violations of the filing requirements do not give rise to a private remedy. Scientex Corp. v. Kay, 689 F.2d 879 (9th Cir. 1982); C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co., 705 F. Supp. 972 (S.D.N.Y.), *aff'd*, 888 F.2d 125 (2d

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In addition to its reporting requirements, section 16(a) also determines who is subject to section 16(b)'s provisions for disgorgement of insider short-swing profits. However, the Act does not precisely define "officer," "director," or "10% beneficial owner." As a result, many questions have been raised as to the scope of section 16's coverage.

Both the courts and the SEC have considered the scope of "officer." SEC Rule 3b-2 provides that under the Act, generally "'officer' means a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." Although expressly refusing to pass on the validity of Rule 3b-2, the Second Circuit adopted a similar functional equivalency test under the terms of the statute.[387] In 1991, the SEC completely revamped its interpretive rules under section 16. As part of this reform, for the purposes of section 16, *officer* is limited to individuals in policy-making positions.[388]

Another problem in determining who is subject to section 16(b) arises in the context of deputization. The Supreme Court has held that where a partnership profited from short-swing transactions in the corporation's stock and designated or deputized one of its partners to sit on that corporation's board of directors, the partnership will be deemed a "director" under the doctrine of deputization.[389] The Supreme Court appeared to require the plaintiff to prove an actual deputizing or agency relationship,[390] but subsequent lower court decisions suggest that it may be enough to show that the potential for abuse is more than a mere possibility.[391] Although it is clear that the mere presence of an interlocking directorate will not be sufficient to

Cir. 1989). However, they can result in criminal sanctions. *E.g.*, United States v. Guterma, 281 F.2d 742 (2d Cir.), *cert. denied*, 364 U.S. 871 (1960).

387. Colby v. Klune, 178 F.2d 872, 875 (2d Cir. 1949):

> ["Officer"] includes, inter alia, a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labeled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative.

Id. at 873.

388. Rule 16a-1(f).

389. Blau v. Lehman, 368 U.S. 403 (1962).

390. *Id.* at 411.

391. Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

create a section 16 deputization,[391] each situation must be determined on its own facts.

Another issue to be considered under section 16 is the effect the timing of the transactions has regarding an officer's or director's assumption of office or resignation. In general, courts tend to find liability if either purchase or sale occurred while the defendant was an officer or director;[393] if both purchase and sale were before or after the defendant held the position, courts tend not to find liability.[394]

In contrast to cases dealing with officers and directors, section 16 provides that where insider status attaches by virtue of 10% beneficial equity ownership, the section applies only where such person was a beneficial owner "both at the time of purchase and sale, or the sale and purchase." The Supreme Court has held that the threshold purchase that pushes the defendant over the 10% floor does not qualify as a "purchase" subject to section 16 and that only purchases made after that date will give rise to liability. Similarly, when a holder of more than 10% first sells enough to bring his or her holdings down to 9.9%, and on the next day liquidates the remaining holdings, the second sale cannot be subject to section 16, even if the two sales were parts of a single prearranged scheme.[395]

Those found to be statutory "insiders" under section 16(a) must disgorge to the issuer any profit realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period.[396] This provision was viewed by Congress as a "crude rule of thumb" or objective method of preventing "the unscrupulous employment of

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392. *See, e.g.*, Popkin v. Dingman, 366 F. Supp. 534 (S.D.N.Y. 1973).

393. *See, e.g.*, Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) (defendant purchased shares while a director, then sold them at a profit after resigning); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (defendant purchased shares before becoming an officer, then sold them after assuming his position).

394. *See* Lewis v. Mellon Bank, 513 F.2d 921 (3d Cir. 1975) (officer who exercised stock option immediately after resigning then sold at a profit not liable under § 16, since he was not an insider at the time of purchase or sale); Lewis v. Varnes, 505 F.2d 785 (2d Cir. 1974). Since such a result appears to be justified by the language of § 16, it has been suggested that such conduct could be used to raise a presumption of reliance on inside information in terms of finding a possible violation of Rule 10b-5. *See* 2 Thomas Hazen, Treatise on the Law of Securities Regulation § 13.5 (2d ed. 1990).

395. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972).

396. 1934 Act § 16(b).

(corporate) inside information."[397] Accordingly, in light of its broad remedial purpose, section 16(b) will require disgorgement of insider short-swing profits even in the absence of any wrongdoing.

Section 16 does not *prohibit* officers, directors, and 10% equity shareholders from short-term trading in the stock of their companies; it simply authorizes the company (or a shareholder suing on its behalf) to recover the profits realized from such trading. The SEC, therefore, has no enforcement responsibilities under section 16. It does, however, have power to adopt rules and regulations exempting transactions from the liability provisions if it finds them to be "not comprehended within the purpose of" section 16(b).[398]

A section 16(b) action is not based on any injury to the plaintiff, but rather is a remedial provision designed to prevent certain types of insider trading abuses. Success in an action under section 16(b) is not dependent on the possession or use of inside information.[399]

An action may be brought under section 16(b) by a shareholder after a demand has been made to and refused by the directors.[400] Section 16(b) actions arise even though the SEC has no enforcement powers under section 16, corporate management is seldom interested in suing itself, and the financial stake for an individual shareholder is generally very small. The greatest incentive for bringing a section 16(b) action is that attorneys' fees will be awarded to the successful plaintiff's attorneys out of the fund created by the recovery.[401] Suit may be filed by a shareholder of record at the time of the suit, as long as that person continues to be a shareholder throughout the trial. The commonplace contemporaneous ownership rule, requiring a shareholder who brings suit to have been a shareholder at the time of the act

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397. *Hearings on S. Res. 84, S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. pt. 15 at 6557 (1934).

398. 1934 Act § 16(b). The SEC has in fact adopted a number of rules exempting transactions. For example, it has exempted certain transactions by registered investment companies; certain large block transactions in connection with a distribution of securities; qualifying employee benefit plans; certain securities acquired in connection with a redemption of another security; certain option exercises and most conversions of convertible securities; and certain transactions involving share subscriptions. For details and a more complete list of exemptions, see SEC Rules 16b-1 through 16b-11.

399. *Hearings on S. Res. 84, S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. pt. 15 at 6557 (1934).

400. Dottenheim v. Murchison, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); Benisch v. Cameron, 81 F. Supp. 882 (S.D.N.Y. 1948).

401. *See, e.g.*, Super Stores, Inc. v. Reiner, 737 F.2d 962 (11th Cir. 1984).

complained of, does not apply in an action under section 16(b).[402] Thus people who purchase their shares after the transactions in question may bring suit. Notwithstanding the possible champerty implications, the courts have held that it is no defense to an action under section 16(b) that the suit was motivated primarily by an attorney's desire to obtain attorneys' fees. Courts generally reason that Congress must have accepted this price in order to achieve effective enforcement of the provision.[403] An action under section 16(b) for disgorgement of profits may be brought in law or in equity.

If a person is found to fall within one of the categories covered by section 16, the next question is whether there has been a "purchase" and "sale." Where there is a "garden variety" cash-for-stock transaction, section 16(b)'s application will be determined by an objective test.[404] However, the courts have also had to decide whether other transactions—so-called "unorthodox" transactions—fall within section 16(b)'s reach. The exercise of an option or a conversion privilege, or the exchange of one security for another, either in a merger or a voluntary transaction, may or may not fall within the statute, depending on the circumstances.

In *Kern County Land Co. v. Occidental Petroleum Corp.*,[405] the Supreme Court addressed the applicability of section 16(b) to sales of the target company's shares by a defeated tender offeror. In finding that a section 16(b) "sale" had not occurred, the Court used a pragmatic analysis of the transaction:

> In deciding whether borderline [unorthodox] transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which

402. Dottenheim v. Murchison, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); Portnoy v. Kawecki Berylco Indus., Inc., 607 F.2d 765 (7th Cir. 1979).

403. Magida v. Continental Can Co., Inc., 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

404. *See, e.g.*, Arrow Distrib. Corp. v. Baumgartner, 738 F.2d 1274 (6th Cir. 1986) (with respect to cash-for-stock transactions, plaintiff need only show that both transactions occurred within a period of less than six months). Other transactions have also been viewed as "orthodox" transactions, requiring the application of the objective test. *See, e.g.*, Gund v. First Fla. Banks, Inc., 726 F.2d 682 (11th Cir. 1984) (sale of convertible debentures followed by purchase of underlying stock; objective test applied); Oliff v. Exchange Int'l Corp., 669 F.2d 1162 (7th Cir. 1980), *cert. denied*, 450 U.S. 915 (1981) (court found "orthodox" transaction even where "purchase" was a repurchase under compulsion of paying a 205% penalty to the IRS for self-dealing in the prior sale and the IRS called the repurchase a "rescission" of the prior sale).

405. 411 U.S. 582 (1973).

Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits.[406]

This "pragmatic" approach was intended to take the place of the "objective" test for "unorthodox" transactions, such as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants."[407] If there is no fear of or potential for section 16(b) abuse in the unorthodox transaction at issue, the pragmatic analysis should find no purchase or sale.[408]

There has also been significant debate over the method of computing a "profit" within the meaning of section 16(b). The apparent majority approach, when there has been a series of transactions within a six-month period, is to match the lowest purchase price against the highest sales price within that period.[409] This method is the harshest of the alternative interpretations, since it catches a profit even in situations where an out-of-pocket loss may exist for all transactions entered into during the six-month period.[410] Furthermore, there is authority to the effect that dividends declared on shares sold at a profit will be considered part of the section 16(b) profit, provided that insider status applied at the time of declaration of the dividend.[411]

Section 16(c). Section 16(c) prohibits certain speculative activities by insiders who must file reports under section 16(a) (10% beneficial owners, officers, and directors). Section 16(c) is aimed at two types of speculative

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406. *Id.* at 594–95 (footnotes omitted).

407. *Id.* at 594 n.24.

408. *See* Thomas Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C. L. Rev. 1 (1975).

409. Arrow Distrib. Corp. v. Baumgartner, 738 F.2d 1274 (6th Cir. 1986); Whittaker v. Whittaker Corp., 639 F.2d 516, 530–32 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

410. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

411. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). *But see, e.g.*, Morales v. Lukens, Inc. 593 F. Supp. 1209, 1214–15 (S.D.N.Y. 1984), relying on Blau v. Lamb, 363 F.2d 507, 528 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (dividends are excluded from the Section 16(b) computztion absent evidence that the defendant manipulated the dividend).

transactions: (1) short sales,[412] or selling the security of the issuer without owning the underlying security; and (2) sales against the box,[413] when the seller delays in delivering the securities. In both instances, the investor's hope is that the price will decline from the time of sale, thus enabling the seller to cover at a lower price. Although these are legitimate speculating devices in certain instances, the practices of selling short and selling against the box are high-risk transactions subject to speculative abuse, particularly by insiders. Section 16(c) thus operates to make it unlawful to sell a security if the selling insider either (1) does not own the security or (2) owns the security but does not deliver it within twenty days or deposit it in the mail in five days.[414]

Regulation of the Marketplace and Securities Professionals

In addition to imposing disclosure requirements on issuers of publicly traded securities, the Exchange Act of 1934 regulates the marketplace. Although the SEC has direct authority, a great deal of market regulation is carried out through its oversight of national exchanges and self-regulatory organizations. Market regulation includes the establishment of fair market practices and minimum-capital requirements for broker–dealers in order to minimize the risk of insolvency. A major goal of this regulation is to assure orderly markets. There are also severe prohibitions against fraudulent and manipulative broker–dealer conduct. Additionally, the SEC and Federal Reserve Board work together in regulating the extension of credit for securities transactions.

Regulation of broker–dealers. Section 15(a) of the Exchange Act requires registration with the Commission of all broker–dealers engaged in interstate business involving securities transactions.[415] Section 15(b)(4) empowers the Commission to hold a hearing and impose disciplinary sanc-

412. A short sale takes place when a seller, believing the price of a stock will fall, borrows stock from a lender and sells it to a buyer. Later, the seller buys similar stock to pay back the lender, ideally at a lower price than he or she received on the sale to the buyer.

413. A sale against the box takes place when the seller, anticipating a decline in the price of stock he or she owns, sells it to a buyer at the present market price, but delivers it later, when (he or she hopes) the market price will have fallen below the sales price, thus creating a paper profit for the seller.

414. There is a good faith exception provided within the statute. Furthermore, the SEC has exempted certain transactions deemed not to violate the policy of the provision. *See* Rules 16c-1, 16c-2, and 16c-3.

415. The only exemption from the registration requirements is for a broker-dealer "whose business is exclusively intrastate and who does not make use of any facility of a national exchange."

tions ranging from censure to revocation of the registration of broker–dealers engaging in certain types of proscribed conduct.[416] Section 15(b)(6) empowers the Commission to impose similar sanctions for the same types of conduct on persons who, although not themselves broker–dealers, are associated or seek to become associated with broker–dealers.

In addition to imposing sanctions arising out of the SEC's direct broker–dealer regulation, the Commission is charged with supervising a securities firm's structure and taking measures to assure its solvency. Section 15(b)(7) requires broker–dealers to meet such operational and financial competence standards as the Commission may establish. The competence requirements include provisions for maintenance of adequate records and standards for supervisory and associated personnel. The SEC also has established financial responsibility requirements in its net capital rule, which sets out the minimum standards of broker–dealer solvency based on the balance sheet.[417]

Section 15(b)(8) requires that all broker–dealers be members of a qualifying self-regulatory organization (either a national exchange or registered securities association).[418]

Section 15(c) of the 1934 Act contains a series of antifraud provisions designed to prohibit securities broker–dealers from engaging in fraudulent practices and conduct. In addition to regulating broker–dealers' financial responsibilities, this provision and others[419] are used most often by the SEC and courts to regulate (1) excessive prices for over-the-counter securities[420]; (2) activities of market makers who deal directly with individual

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416. For example, the SEC may impose sanctions after a hearing (1) when a broker–dealer makes false filings with the Commission; (2) when the broker–dealer, within the past ten years, has been convicted of certain crimes or misdemeanors involving moral turpitude or breach of fiduciary duty; (3) when the broker–dealer has willfully violated or aided in violating any federal securities law or rule; and (4) when the broker–dealer has been barred by the SEC or enjoined from being a broker–dealer. 1934 Act § 15 (b)(4).

417. Rule 15c3-1, the net capital rule, is based on a complex balance sheet test for solvency. *See, e.g.*, SEC Study on the Financing and Regulatory Capital Needs of the Securities Industry (Jan. 23, 1985).

418. Currently, there are nine national exchanges registered under § 6 of the Act and one securities association registered under § 15A (the National Association of Securities Dealers).

419. Most notably § 17(a) of the 1933 Act, and § 10(b) of the 1934 Act and rules promulgated thereunder.

420. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943) (violation of the securities laws where broker–dealer made high-pressure "cold calls," convincing purchasers to pay an undisclosed 16%–40% markup over market value of securities).

customers[421]; (3) generation of commissions by excessive trading in customers' accounts ("churning") and other fraudulent trading practices[422]; and (4) undisclosed interests of investment advisers in the stocks they recommend.[423]

Beyond the SEC rules and the additional requirements that may be imposed by the applicable self-regulatory organizations, broker–dealers are, of course, subject to common-law duties and fiduciary obligations. For example, a broker–dealer is prohibited from recommending a security unless he or she has actual knowledge of the characteristics and fundamental facts relevant to the security in question. Also, the recommendation must be reasonably supported by the facts.[424]

Furthermore, there are obligations imposed with regard to the broker-dealer's duty to "know the customer." This duty is frequently imposed by rules of self-regulatory organizations but also arises from general fiduciary duties between brokers and their customers. This duty requires that a broker be certain that the customer understands the risks of investment (or, in a discretionary account, that the broker understands the objectives of the

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421. *See, e.g.*, Alstead, Dempsey & Co., Exchange Act Release No. 20,825 (1984) (in over-the-counter market, where market maker's customers hold 95.7% of the stock of the company at issue, and market maker controls the market, markups of 11%–20% over transactions in the independent interdealer market are excessive); Chasins v. Smith, Barney, 438 F.2d 1167 (2d Cir. 1970) (failure to disclose market-maker status is nondisclosure of a material fact in violation of the securities laws). *See also* SEC Rule 10b-10.

422. *See, e.g.*, Mihara v. Dean Witter, 619 F.2d 814 (9th Cir. 1980) (where broker–dealer has control or de facto control of account, a high turnover rate, particularly of securities unsuitable to the complaining investors, generates excessive commissions in violation of the securities laws); Nesbit v. McNeil, 896 F.2d 380 (9th Cir. 1990) (in a churning case, a successful plaintiff is entitled to receive at his or her option as damages the decline in value of his or her portfolio, the amount of excess commissions generated by churning in the account, or both).

423. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (failure to disclose purchases of securities prior to making recommendation constituted a violation of Investment Advisers Act § 206).

424. This "know your security" requirement is an extension of the common-law doctrine of "holding out." The Second Circuit has held that to satisfy this requirement, a challenged broker–dealer must show that there was (1) an adequate and reasonable basis for the recommendation; (2) a reasonable independent investigation (the standards of which vary based on the nature of the security); (3) disclosure of essential information about the company to the investor; and (4) disclosure to the investor of any lack of information and the risks that may therein arise. Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969).

customer, e.g., financial security as opposed to speculation). Although the fiduciary obligations are high, disciplinary actions have been few, and the overwhelming majority of cases have denied the existence of a private remedy by an injured investor based solely on the violation of an applicable rule of a self-regulatory organization.[425] On the other hand, it is clear that if an injured customer can state the equivalent of a Rule 10b-5 violation, including showing the requisite scienter, materiality, reliance, causation, damages, and deception, a violation of the "know your customer" rule will be actionable.[426]

It is to be expected that relatively few broker–customer disputes will end up in the courts, especially because of the 1987 Supreme Court decision holding that predispute arbitration agreements are enforceable.[427] Since that decision, predispute arbitration agreements have been increasingly popular. As is the case with arbitration generally, the scope of review is extremely limited, and the appropriate standard of review is "manifest disregard of the law."[428]

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425. *See, e.g.*, Carrott v. Shearson Hayden Stone, Inc., 724 F.2d 821 (9th Cir. 1984); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); Klock v. Lehman Bros. Kuhn Loeb, Inc., 584 F. Supp. 210 (S.D.N.Y. 1984). *Contra* Buttry v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

426. *See, e.g.*, Pelletier v. Stuart-James Co., 863 F.2d 1550 (11th Cir. 1989); Lopez v. Dean Witter Reynolds, Inc., 591 F. Supp. 581 (N.D. Cal. 1984).

427. Shearson Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987).

428. *E.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 933 (2d Cir. 1986).

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Appendix B

Statutory Conversion Charts

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About the Federal Judicial Center

The Federal Judicial Center is the research, education, and planning agency of the federal judicial system. It was established by Congress in 1967 (28 U.S.C. §§ 620–629), on the recommendation of the Judicial Conference of the United States.

By statute, the Chief Justice of the United States chairs the Center's Board, which also includes the director of the Administrative Office of the U.S. Courts and six judges elected by the Judicial Conference.

The Court Education Division provides educational programs and services for non-judicial court personnel such as those in clerks' offices and probation and pretrial services offices.

The Judicial Education Division provides educational programs and services for judges. These include orientation seminars and special continuing education workshops.

The Planning & Technology Division supports the Center's education and research activities by developing, maintaining, and testing technology for information processing, education, and communications. The division also supports long-range planning activity in the Judicial Conference and the courts with research, including analysis of emerging technologies, and other services as requested.

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The Research Division undertakes empirical and exploratory research on federal judicial processes, court management, and sentencing and its consequences, often at the request of the Judicial Conference and its committees, the courts themselves, or other groups in the federal system.

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Part C
OTHER INFORMATION

PART B
INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FEE SCHEDULE FOR CERTAIN FILINGS AND SERVICES UNDER THE SE... THE SECURITIES EXCHANGE ACT OF 1934, THE INVESTMENT ADVISE... INVESTMENT COMPANY ACT OF 1940[1]

The Securities and Exchange Commission has adopted a fee schedule for certain filings and... 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Inves... will be no refund of any fees.

The rules impose the following fees and charges:

Securities Act of 1933 and Investment Company Act of 1940

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